MARCH 2010

SEC CLARIFIES NEW DISCLOSURE RULES FOR OIL AND GAS RESERVES

On December 31, 2008, the United States Securities and Exchange Commission (the "SEC") adopted amendments to its oil and gas reporting requirements with the issuance of Final Reporting Release No. 78, *Modernization of Oil and Gas Reporting*. It was designed to modernize the oil and gas disclosure requirements of Regulation S-X and Regulation S-K in response to technological improvements in the industry over the past several years. Since its issuance, however, many questions have been raised regarding its application by participants in the industry. In response to these questions, the SEC clarified the final report in a question-and-answer format on October 26, 2009.[1] This *Commentary* analyzes the guidelines provided by the SEC with respect to certain key disclosure issues and the impact that those issues may have on the ability of oil and gas companies to report their reserves.

PUDs: THE FIVE-YEAR RULE

The final report permits reporting companies to classify undeveloped reserves as "proved" if the development plan for those reserves provides for drilling within five years of being booked. Reserves that remain undeveloped for more than five years from the date they were booked may still be classified as proved undeveloped reserves ("PUDs"), but only if it is justified by "specific" circumstances. Even though the final report clearly states that the intent of the five-year limit is not to exclude projects that typically take longer to develop, the SEC's recent guidance on the issue suggests that the circumstances in which a company will be given longer than five years to develop its PUDs are limited.

If companies desire to book PUDs that will remain undeveloped for five or more years, they should document and be prepared to defend the "specific" circumstances that justify the extended timeline. The SEC has enumerated certain factors that companies

1 The October 26, 2009, "Compliance and Disclosure Interpretations: Oil and Gas Rules" can be viewed at http://www.sec.gov/divisions/corpfin/guidance/oilandgas-interp.htm.

should consider when determining whether those "specific" circumstances exist, namely, (i) the company's history of developing comparable long-term projects; (ii) the company's level of significant ongoing development activities in the area to be developed; (iii) the amount of time the reserves have remained undeveloped since they were discovered; (iv) the extent to which the company has followed a previously adopted development plan with respect to those reserves; and (v) the extent to which the extended timeline is a result of external factors as opposed to internal factors (such as shifting resources to develop properties with higher priority).

It is important to note that the existence of certain external factors—such as restrictions on drilling on federal lands—may in and of themselves justify an extended timeline for development. Projects that the SEC has identified in this category include projects that require the construction of offshore platforms or the development of reserves located in urban areas, remote locations, or environmentally sensitive locations. Although the SEC has not stated that this is an exhaustive list of long-term projects, it has said that the circumstances in which a company will be able to book PUDs attributable to projects with development horizons longer than five years will be very narrow. Thus, going forward, companies desiring to book these types of PUDs would be well advised to carefully document the reasons for their delayed development (based on the factors listed above) and be prepared to defend them as necessary.

The SEC has also not clarified whether the five-year period starts from the time the reserves were first booked as PUDs or from January 1, 2010, the effective date of the final report. After reviewing the SEC statements on the issue, however, many commentators believe that the clock begins to run when the reserves were first booked. Thus, companies should be prepared to justify the classification of previously booked PUDs that have not been, or will not be, developed for five years from the date they were booked.

Companies unable to justify the five-year delayed development of a PUD location may be required to write it off. The loss of previously recognized reserves has a number of adverse consequences for a company that may range from increased costs of capital to violations of covenants in the company's loan agreements or indentures. To mitigate some of these results, a company may consider reclassifying the reserves as "probable." Such a reclassification would give a company the ability to disclose the reserves, albeit not as proved reserves.[2] Also, companies considering this option need to keep in mind that the disclosure of unproved reserves without associated proved reserves are permitted only in rare cases. Thus, it may be difficult to exercise this option if the reserves are located in an area that does not also contain proved reserves.

Companies that cannot justify booking PUDs should refrain from referring to those reserves as proved in press releases or other informal formats. Companies that inaccurately refer to such reserves as proved in informal communications may violate the new rules, even if those reserves are not assigned as proved in a company's official filings.

Finally, under the final report, a company must also provide evidence that it adopted a development plan for a PUD location at the time it was booked and that this development plan contained a "final investment decision" showing that the reserve location will be developed within five years. The mere intent to develop the location within five years, without quantifiable evidence supporting that plan, is not sufficient. How much more than mere intent must be demonstrated to constitute a final investment decision remains an open question. Presumably, an actual authorization for expenditure is not required in order to meet this test, since those are not typically given until shortly before the well is actually drilled. So an authorization for expenditure may not come for months, or in some cases years, after the development plan calling for the well to be drilled has been approved by the company. The SEC will likely be called upon in the near future to resolve this question. However, until it does so, companies should take care to document their long-term schedules and budgets (including any internal approvals) for developing reserves that they have booked as PUDs. While this may ultimately not be sufficient to satisfy the requirement for a "final investment decision," it is evidence of the company's intent to develop the PUDs within the prescribed timeframe that is more concrete than a mere statement.

2 If probabilistic methods are used, the company would be required to provide evidence that there is at least a 50 percent probability that the actual quantities recovered will equal or exceed the estimated proved, plus probable reserves.

RELIABLE TECHNOLOGY

The new "reliable technology" rule permits companies to establish reserve estimates and classify reserves if they show that consistent and repeatable field-tested technology was used in reaching their determinations. This new rule is still unclear in certain respects because the SEC has not yet specified required rates of success, nor has it published a list of reliable technologies. Instead, it has stated that the term "reliable technology" will likely be defined over time by industry consensus with independent engineering firms leading the way.

A company that is unable to justify the reliability of its technology upon request from the SEC risks the possibility of a write-off. Until further guidance on this point is provided, companies should adopt internal procedures to collect empirical evidence of the success rate for the technology they used to establish reserve estimates and categories. This documentation may be required if the reporting company has not previously disclosed reserve estimates in a public filing or is disclosing material additions to, or increases in, reserve estimates. It is important to note that while the evidence submitted must provide enough information for the SEC to determine the reliability of technology, the SEC has stated that the evidence may remain general enough to prevent the disclosure of proprietary technology at a level of detail that would cause competitive harm.

Also, the SEC has not provided guidance as to whether every company is required to document individually the reliability of the same technology. Thus, companies that rely on technology used by other companies to determine reserve estimates should independently justify their use of the technology with their own empirical evidence.

Maintaining detailed documentation on the technology used to prove reserves may also help a company take advantage of a new rule permitting the assignment of PUDs to horizontal locations offsetting the toe of an existing horizontal producing well. The SEC clarified that PUD classification is permissible if the horizontal location moves in the same direction of other successful, analogous producing horizontal wells and if the technological evidence supports the assignment with "reasonable certainty." Thus, companies intending to assign PUDs to horizontal locations should adopt internal procedures to collect evidence that the technology they use works with reasonable certainty. This is particularly important given the recent focus on shale and other resource plays that are developed through the use of horizontal drilling.

SEALED FAULT BLOCKS

The SEC prohibits companies from booking any category of reserves located in unpenetrated, pressure-segregated (*i.e.,* sealed) fault blocks. The SEC has not stated whether any exceptions to this absolute rule exist. This has many participants in the industry questioning whether the long-standing practice of assigning probable and possible reserves to sealed fault blocks that lie up or down dip from a stratigraphically equivalent producing block has been eliminated. However, several commentators have suggested that companies may overcome the prohibition through technological evidence. For instance, they may justify booking reserves located in a sealed fault block if empirical evidence shows a high rate of success in drilling similar fault blocks. However, until the SEC approves this practice, companies should refrain from booking reserves located in sealed fault blocks to ensure compliance with the new rules.

TWELVE-MONTH AVERAGE PRICING FOR RESERVES ESTIMATION

The SEC requires companies to disclose the year-end economic producibility of proved reserves. In making this calculation, companies must use the unweighted average of oil and gas on the first day of each month for 12 months preceding the end of the company's fiscal year. This is a change from the prior SEC requirement of calculating the year-end economic producibility of a reserve based on oil and gas prices on the last day of the year.

Periods of depressed or fluctuating oil and gas prices may result in lower reported valuations for companies under this new rule. For instance, consider the example of a company that, throughout 2009, sold all of its oil production at the West Texas Intermediate price and all of its natural gas

production at the Henry Hub price. Under the new rules, the lower price of oil and gas in the beginning of 2009 would have resulted in an SEC-mandated oil price of $61.08 per barrel and a natural gas price of $3.87 per MMBtu. By contrast, under the old rule, the oil price would have been $79.36 per barrel and the natural gas price would have been $5.79 per MMBtu.[3] In this situation, to highlight their relative effect, companies might consider disclosing the value of their reserves under both sets of rules.

SUMMARY AND CONCLUSIONS

The goal of the new oil and gas disclosure rules is to help investors evaluate the value of oil and gas companies by providing investors with a more meaningful and comprehensive picture of a company's oil and gas reserves. The SEC's recent disclosure and compliance interpretations further this goal by clarifying several important reporting requirements in Regulation S-X and Regulation S-K. Nevertheless, certain questions remain for companies trying to properly apply the new rules in their disclosure filings, such as the proper methodology for the classification of long-term PUDs and the definition of "reliable technology" used to prove up reserves. Until the SEC provides further clarity, companies should take a conservative approach to booking reserves, provide complementary disclosure where appropriate, and adopt internal procedures to collect sufficient evidence to justify their reserve estimates and categories.

3 These 2009 oil and gas prices can be found at http://www.earthtimes.org/articles/show/forest-oil-announces-2009-estimated,1150211,forest-oil-announces-2009-estimated.shtml.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Shahid A. Ghauri
+1.832.239.3702
sghauri@jonesday.com

J. Mark Metts
+1.832.239.3759
markmetts@jonesday.com

Jeffrey A. Schlegel
+1.832.239.3728
jaschlegel@jonesday.com

Kathleen R. McLaurin
+1.214.969.4511
krmclaurin@jonesday.com

James E. Vallee
+1.832.239.3732
jevallee@jonesday.com

Angela Olivarez
+1.832.239.3706
aolivarez@jonesday.com

Nicholas C. Wittich
+1.832.239.3856
ncwittich@jonesday.com