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# Views from the summit— staff comments on companies' compliance with the SEC's amended oil & gas reserves disclosure rules

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Marc H. Folladori

*Partner*

713-238-2696

[mfolladori@mayerbrown.com](mailto:mfolladori@mayerbrown.com)

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# Overview

- Securities and Exchange Commission (SEC) oil & gas reserves disclosure rules – amended 12/31/08
- Companies' experience in complying with amended rules
- Insights from SEC staff — comment letters on companies' compliance with amended rules
- Compliance & Disclosure Interpretations (CDIs)
  - May 2013 addition
- Ancillary items
  - Dodd-Frank extractive resources disclosure rule vacated; but conflicts minerals rule was upheld

# Development of SEC rules and US accounting rules on oil and gas reserves disclosures

- Before 1978, no reserves disclosure rules *per se*
- In response to oil crisis and 1973-74 oil embargo, US Congress in 1975 directed SEC to develop accounting standards to disclose reserves of E&P companies
  - “Reserve recognition accounting” (RRA) - never gained traction
- From 1975-1982, SEC and FASB tried to flesh out RRA, ground rules for full cost and successful efforts accounting methods, and supplemental oil & gas disclosure rules
- Resulted in basic structure of today’s disclosure standards

## Shell Oil SEC enforcement proceedings (2004)

- SEC enforcement actions against Shell for overstatements of volumes and present values of its reserves in filings
- Cease-and-desist order consented to by Shell cited:
  - Internal guidelines failed to meet technical requirements of SEC reserves disclosure rules
  - Lack of effective internal controls
- Shell paid a penalty of \$120 million, committed \$5 million to implement an internal compliance program under legal director and agreed to enhance its group's legal function
- The enforcement actions, highlighting outdated SEC rules, were criticized by many

## Amended rules (adopted December 2008, effective December 2009)

- Principal changes to former rules:
  - Use a 12-month *average* price, not the year-end price, per unit of production in determining economic producibility
  - Included hydrocarbons from unconventional/non-traditional sources (*e.g.*, bitumen, synthetic oil, oil sands, etc.)
  - The “reasonable certainty” test (used to estimate the economic producibility of hydrocarbons in order to be classified as proved reserves) was revised to conform to the Petroleum Resources Management System (PRMS) standard
  - Less stringent test applied to establish PUDs beyond one offsetting drilling unit

## Amended rules (adopted December 2008, effective December 2009)

- Principal changes to former rules (continued):
  - “5-year rule” for booking and maintaining booking of PUDs
    - Undrilled locations can be classified as having undeveloped reserves if development plan has been adopted indicating they are scheduled to be drilled within 5 years, unless *specific circumstances* justify longer time
    - PRMS guidelines indicate 5 years is benchmark for reasonable timeframe to initiate the development of reserves, although they recognize that the timeframe depends on the specific circumstances
  - New definition - “reliable technology” - broadened types of technologies that could be employed to establish reserves
  - Disclosure of probable/possible reserves permitted
  - Independent engineers’ reports must be filed in annual reports

## Companies' experience with amended rules

- First round of staff comment letters issued in 2010-11 with respect to annual reports fye 12/31/09
- For first year's filings, staff principally focused on *whether* companies were complying with amended rules
- Second round (2011-12) – for annual reports fye 12/31/10; and third round (2012-13) – for annual reports fye 12/31/11:
  - Comments centered more on *how* companies were complying
  - Considerably more detailed, granular comments and requests

## Observations – the 5-year rule

- Strong presumption against booking:
  - New PUDs that are unlikely to be drilled within 5 years; and
  - PUDs that have remained on books for more than 5 years

— in either case, PUDs should be de-classified as such, unless “specific circumstances” justify longer time
- Any extension beyond 5 years should be exception - not rule
- What are “specific circumstances” to justify longer time?
  - Determination must take into account all facts and circumstances
  - Examples of situations that *might* justify longer time period: projects involving construction of offshore platforms; development in remote locations, urban locations or environmentally sensitive areas



## Observations – the 5-year rule and “specific circumstances” exception

- Factors to consider in justifying bookings > 5 years:
  - Level of ongoing significant activities in development area
  - Company’s historical record at completing development of comparable long-term projects
  - The amount of time the company has maintained the leases or booked the reserves without significant development activities
  - Extent to which the company has followed a previously adopted development plan (*e.g.*, changes without implementation)
  - Extent to which delays in development are due to external factors (*e.g.*, restrictions on development on federal lands), instead of internal factors (*e.g.*, reallocating development resources to higher-priority properties)

## Observations – the 5-year rule

- *Development plan* must have been adopted for reserves to be classified as “undeveloped oil and gas reserves”
- The mere *intent* to develop, without more, does not constitute adoption of a development plan, and would not by itself justify recognition of reserves
- Adoption of a development plan requires a *final investment decision* indicating undrilled locations are scheduled to be drilled within 5 years, unless specific circumstances justify longer time period
  - “Scheduled to be drilled” means the same as PRMS “initiation of development”

## Observations – the 5-year rule

- Companies arguing for booking PUDs for > 5 years prompted many extensive staff requests for backup
  - Details on development plans, drilling schedules & project costs
  - Mathematical unlikelihood of converting all PUDs in 5 years
  - Company’s historical rates of conversion of PUDs to PDs would not support estimates
  - Apparent lack of liquidity and financing resources to carry out development program
  - Limited access to fracking services was not a factor that was “outside the control” of the company
  - Effects on PUDs where drilling program was curtailed due to decreased natural gas prices

## Observations – progress in converting PUDs to PDs

- Disclosure is required regarding PUD quantities:
  - Material changes in PUDs, including PUDs converted to PDs;
  - Investments, progress made during year to convert PUDs to PDs, including capital expenditures; and
  - an explanation of why material amounts of PUDs in individual fields or countries remain undeveloped for 5 years or more
- Material changes in PUDs require enhanced disclosures
  - Provide information separately on conversions, discoveries, extensions, divestments, acquisitions, revisions of prior estimates and results from improved recovery activities
  - Disclose capital costs expended to convert PUDs to PDs

## CDI Question 106.1 – developed Oil & gas reserves definition

- Before 2008, reserves booked from improved recovery techniques (*e.g.*, fluid injection) to increase EURs could be classified as PDs only if a production response resulted
- Amended definition for developed reserves applies to developed reserves of all categories, and no longer requires production response to be deemed “developed”
- CDI 106.01: if all \$’s have been expended to install or implement the improved recovery technique, but production response is not yet achieved, reserves can still be classified as PDs so long as criteria for “proved reserves” and “developed reserves” are met

# Observations – production and development information

- Present activities and trends in development of prospects
  - Situations where crude oil reserve quantities appear to represent a declining portion of total proved reserves
  - Separate disclosure of production quantities, average sales prices and average production costs per unit of crude oil, from:
    - Production quantities, transfer prices and production costs for bitumen;
    - Production quantities, costs and sales prices for natural gas liquids (NGLs)
  - Deficiencies in disclosures of production from fields/countries that contain  $\geq 15\%$  of a company's total proved reserves
  - Requests for information on trends in development activities/costs, production costs and sale prices

## Observations – “reliable technology”

- Defined as grouping of 1 or more technologies (including computational methods) that have been *field tested* and *demonstrated* to provide *reasonably certain* results with *consistency and repeatability* in the *formation being evaluated* or in an *analogous formation*
  - No other definition provided – company has burden of establishing and documenting the technology(ies) that provide reliable results, consistent with the definition
  - Upon request from the staff, information on a company’s reliable technology should be provided in support of any reserves estimates then under review

## Observations – “reliable technology”

- Expanded disclosures on technologies and methods used
  - Particularly where additions to proved reserves estimates were disclosed as being based on use of reliable technology
    - Software program indicating average well life of PUD locations beyond 5 years was not adequate evidence of reasonable certainty — especially where no analogy existed for estimated life of producing wells
    - General descriptions (*e.g.*, “microseismic operations and reservoir simulation modeling”) not adequate
    - Companies required to describe and discuss generally the technology, and explain the methods used in applying the technology
  - What were actual technologies used, were they reliable in the geological environments applied, did company also use other technology/methods (such as production flow tests)?



## Observations – changes in estimates; revisions of proved reserves

- Changes in estimates/revisions of reserves year-to-year
  - Significant revisions required explanation – were there any major discoveries, other favorable events? Or decisions to curtail development efforts in certain fields or areas? Or declines in hydrocarbon prices during the year?
  - Downward revisions due to production performance required extensive disclosures, including steps taken by company to avoid further downward revisions
  - Some property acquisitions prompted comments/requests for further information (*e.g.*, where large amount of PUDs had been assigned to properties purchased during year from 3<sup>rd</sup> party)

## Observations – financial and accounting comments

- Additional disclosure concerning various costs
  - Separate capitalized costs for PUDs from those for PDs; more explanation on how companies categorized property acquisition costs, exploration costs, development costs, production costs, methods of cost allocation, etc.
- Non-GAAP financial measures
  - E.g., “EBITDAX,” “field level segment operating earnings,” etc.
- Questions about actual and potential impairments
  - Popular topics: ceiling tests, impairment analysis, identification of asset groups, assumptions (including classification and pricing of reserves used to determine revenues, current economic events and depletion calculations)

# Observations – engineering information

- Engineering information and reports
  - Clarifying whether report was “review” or “audit”
  - Deficiencies in the disclosures required to appear in reports
  - Requests for “supplemental information” – spreadsheets, summary income forecasts for proved reserves, individual income forecasts and exhibits (*e.g.*, maps, volumetric calculations, decline parameters, etc.)
  - Inconsistencies between company’s estimates and the report
  - Deficiencies in disclosure of principles/standards followed
  - References to “boilerplate” reserve methodologies rather than to the actual methodology applied in estimating reserves

## Observations – hydraulic fracturing and pollution

- Hydraulic fracturing activities and related liabilities – requests for additional disclosures/information
  - Specific disclosures of operational and financial risks (*e.g.*, potential underground migration, surface spillage, mishandling of fluids, contents of and chemical additives to fracking fluids, wastewater disposal)
  - Disclosures on potential liabilities for contamination, contractual indemnification obligations, insurance coverage and limits, environmental impact from operations and risks associated with state and federal fracking regulations
  - Enhanced disclosures about pollution risks, potential liabilities and risks, etc., were also requested from offshore producers and drilling companies

# Observations – miscellaneous

- Other topics
  - Companies' operations in Iraq, Iran, Syria and Sudan
  - Cash and investments held by foreign subsidiaries
  - Cyber attacks
  - Leases/concessions having PUDs that will expire soon
  - Volumetric production payments, marketing and derivative contracts that covered most of a company's production
  - “Probables” and “possibles” disclosures
  - Internal controls and persons overseeing estimation process
  - Required governmental approvals (environmental, construction, etc.), and when the approvals were expected

## Dodd-Frank §1504 Extractive Resources Disclosure Rule vacated by US federal court – July 2, 2013

- Rule 13q-1 adopted in 2012 requiring resource extraction issuers (oil, gas, mining companies) to disclose certain payments made to the US or foreign governments
- Similar to Extractive Industries Transparency Initiative
- Court found:
  - Nothing in §1504 required that there be public disclosure of the full resource extraction payments reports – instead, the statute refers to a public *compilation* of the payments information that must be made public “to the extent practicable”
  - The SEC did not provide any exemption for disclosure of resource extraction payments made to governments in countries where that disclosure is prohibited

## Process of dealing with SEC staff comments

- Despite informal-sounding procedures, dealing with SEC staff is still dealing with a federal governmental agency
- Staff comments may be first step in process of discovering/uncovering material non-compliance with regulations and violations of law – can result in:
  - Amended and restated financial statements
  - Amended and restated petroleum engineering reports
  - Declines in stock price and impaired ability to attract capital
  - Internal investigations
  - Legal proceedings by governmental entities and/or private claimants