

MAYER • BROWN

# SEC Staff Comments on Reserves and Related Disclosures

2011 Ryder Scott Reserves Conference

Marc H. Folladori  
*Partner*

713-238-2696  
mfolladori@mayerbrown.com

September 2011

Mayer Brown is a global legal services organization comprising legal practices that are separate entities ("Mayer Brown Practices"). The Mayer Brown Practices are: Mayer Brown LLP, a limited liability partnership established in the United States; Mayer Brown International LLP, a limited liability partnership incorporated in England and Wales; Mayer Brown JSM, a Hong Kong partnership, and its associated entities in Asia; and Tauil & Chequer Advogados, a Brazilian law partnership with which Mayer Brown is associated. "Mayer Brown" and the Mayer Brown logo are the trademarks of the Mayer Brown Practices in their respective jurisdictions.

# Background

- Dec 31, 2008 – SEC adopts amended oil and gas disclosure rules
- Oct 2009 – SEC Corp Fin Div staff issues Compliance & Disclosure Interpretations (CDIs) regarding new rules
- Dec 31, 2009 – fiscal year-end of companies first required to comply with and report under new rules
  - Form 10-Ks and 20-Fs filed with respect to fiscal 2009; also registration statements (Form S-1s, etc.)
  - Staff of Corp Fin Div issues comment letters with regards to disclosures in filings; companies respond to comments

# Our review

- In 2010, we reviewed a sampling of certain E&P companies' 10-K filings for their fiscal year ended Dec 31, 2009; focused on their disclosures of:
  - 'Reliable technology' and its role in (i) increasing PUDs & (ii) booking PUDs attributable to more-than-1-direct-offset away
  - '5-year rule' with respect to PUDs added to/remaining on books
- In 2011, we reviewed certain SEC staff comment letters on companies' 10-K and 20-F filings for their 2009 fiscal year
  - Most letters dealt with engineering questions relating to 5-year rule and reliable technology, but many dealt with miscellaneous failures to follow the rules' black-letter disclosure instructions

# Categories of disclosure deficiencies under new rules cited by SEC staff in comment letters

- Five-year rule
- Development of PUDs
- Reliable technology
- Reasonable certainty of production within a stated time
- Failure to disclose specific principles/standards followed
- Inconsistencies between 3<sup>rd</sup>-party engineers' reports and internal company estimates
- Qualifications of technical persons
- Significant changes in proved reserves

## Five-year rule

- PUDs converted at ‘mathematically impossible’ rates
- How to convert PUDs to proved developed in 5 years
  - Provide volumes/percentages of PUDs converted in prior years
- Explain why PUDs remained as such on books for 5 years
  - Remove from proved category if no reasonable certainty of development within 5 years
- Explain reasons for material changes in PUDs year-to-year
- More disclosure about significant properties and their development schedule
  - Where ‘special circumstances’ exception to 5-year rule was relied on, disclose estimates for particular PUD locations & conditions preventing their earlier booking as producing

# Development of PUDs

- Disclosures for development of undeveloped locations
  - If special recovery methods are to be used, has investment decision been made yet on special recovery equipment?
  - If liquidity to fund development plans looks insufficient, discuss how PUDs will be developed within time frame disclosed
  - Shortage of hydraulic fracturing services causing delay in development to extend past 5-year date constituted a ‘known factor’ at date of estimation; and therefore not sufficient to justify ‘special circumstances’ exception
  - Newly-booked PUDs offset by 2 or more locations away from producing well required additional disclosures
    - Statistics of company’s drilling history for PUDs offset by 2 or more locations; fuller explanation of added reserves attributable to each of the applicable factors under new rules, including ability to book PUDs more than one location away from producer

# Reliable technology

- Company must be able to document technology(ies) that provide reliable results to establish reasonable certainty of economic probability more than one direct offset away
  - Describe, discuss generally and explain actual, specific methods and technologies applied
    - Broad, imprecise descriptions do not meet “reasonably certain” threshold
    - Greater detail requested by staff (e.g., describe what the ‘microseismic operations and reservoir simulation modeling’ employed by the company were)
  - Explain why reliable in specific geological environment in which applied
  - Disclose how many proved reserves determined by alternative methods/technologies used

# ‘Reasonable certainty’ as to amount and timing of production of proved reserves

- If ‘reasonable certainty’ on amount and timing not assured, then those reserves should be removed
  - ‘Reasonable certainty’ from a given date forward, from known reservoirs and under existing operating conditions, operating methods and government regulations
  - Terms like ‘appears to have enhanced’ or ‘apparently economic’ were unclear as to whether reasonable certainty threshold met
  - Statements like ‘there are uncertainties’ in companies’ reserves estimates ‘due to factors outside our control’ will require a precise discussion of those factors



# Other deficiencies noted

- ‘Industry principles’ disclosure
  - Estimates prepared according to ‘generally accepted petroleum engineering and evaluation principles’ not adequate
  - References to February 19, 2007 Society of Petroleum Engineers publication – *Standards Pertaining to the Estimating & Auditing of Oil and Gas Reserves Information*’ are acceptable
- Failure to discuss company’s specific internal controls used to ensure objectivity in estimation processes
- 3P independent petroleum engineers’ reports not complying with Reg S-K Item 1202(a)

## Other deficiencies noted (continued)

- Failure to record proved reserves attributable to a significant discovery with production expected soon
- Failure to disclose qualifications of technical company person responsible for overseeing/accepting 3P engineer reserves estimates or audit
- Material changes in proved reserves without a general discussion of technologies used to establish appropriate level of certainty for estimates from material properties
- Where proved oil reserves included NGLs in sufficient quantities, failure to either separate & disclose the 2 products, or explain why they should be grouped together

# Case history - Petrohawk Energy Corp.

## • 2010 filing & comments

- 10-K fye 12/31/09 filed on Feb 23
- First staff comment letter: Apr 27 (14 comments)
- Company response letter: May 12; made some confidentiality treatment requests
- Staff response to May 12 company letter: June 23
- Company response to June 23 staff letter: July 2
- Staff 'no further comments' letter: July 16
- Topics covered

## • 2011 filing & comments

- 10-K fye 12/31/10 filed on Feb 22
- Staff comment letter: March 31 (dealt with disclosures regarding delivery commitments of natural gas to joint venture)
- Company response letter: Apr 11
- Staff 'no further comments' letter: Apr 13

# SEC staff subpoenas regarding proved developed producing shale gas wells & reserve estimates

- Hearsay:

- SEC's response to *New York Times* article

- Trying to better understand process

- Subpoena from Fort Worth Regional Office of SEC: '*In the matter of certain shale producers: Fact-finding inquiry.*'

- Followed up by correspondence

- Tailored to companies having significant shale production – generally smaller companies with large volumes of proved reserves in shale in relation to total reserve volumes

- 'How are you estimating your shale reserves and booking those reserves?'

## Recommendations and conclusion

- If you are shale-rich, topics of inquiry of NY Times article and SEC subpoenas should be addressed or at least well-supported (support for decline curve analysis, unit cost estimates, estimated ultimate recovery (EUR), etc.)
- Document and explain support for booking PUDs more-than-1-direct-offset away from producing location
- Exceptions to 5-year rule for PUDs because of ‘special circumstances’ are construed narrowly by SEC staff
- Read the Rules!
- Each company and its properties are different; tailor each company’s disclosures to its own circumstances when complying with rules or relying on an exception to them