This Article discusses compliance with the 2008 amendments to the oil and gas disclosure rules for public companies. It provides a summary of two significant reserves-related disclosure rules introduced by the amendments: a five-year rule for proved undeveloped reserves (PUDs) and a rule permitting companies to prove their reserves through reliable technology. By examining SEC comment letters in response to the first wave of Form 10-K filings under these new rules, this Article provides valuable insight into the SEC’s main areas of focus under the amended disclosure regime.

In December 2008, the Securities and Exchange Commission (SEC) adopted amendments to the disclosure rules for public companies in the oil and gas exploration and production industry. The amendments were a significant development because they were the first substantial changes to the rules in three decades. Calendar year-end filers were first required to comply with the new rules with respect to the disclosure in their annual reports on Form 10-K for the fiscal year ended December 31, 2009. The comment letters issued by the SEC staff in 2010 and early 2011 on these first Form 10-K filings provide valuable insight into the staff’s views on appropriate compliance with the new disclosure rules.

This Article:
- Provides a brief overview of two of the most significant rule changes affecting reserves-related disclosure:
  - a new five-year rule for proved undeveloped reserves (PUDs) (see Five-year Rule for PUDs); and
  - a broadened authorization permitting companies to prove their reserves by the application of reliable technology (as that term is defined in the rules) (see Use of Reliable Technology to Prove Reserves).
- Examines the first wave of comments from the SEC staff on company disclosure under these two rules (see The SEC Comment Letters).
- Lists some of the other topics raised by the SEC staff in their comment letters on oil and gas disclosure (see Other Topics Raised in the SEC Comment Letters).

For definitions of key reserves-related terms used in this Article, see Box, Key Reserves-related Terms.

OIL AND GAS DISCLOSURE RULES: BASIC FRAMEWORK AND THE 2008 AMENDMENTS

The SEC first adopted special disclosure rules for oil and gas companies, including reserves classifications, in 1978 and 1982. One of the SEC’s goals in establishing reserve classifications was to provide a common framework for estimating the quantities of oil and gas associated with a company’s properties and projects.

The extent and pace of changes in the oil and gas industry, and public concern that the SEC’s reserves disclosure requirements
Complying with the 2008 Amendments to the Oil & Gas Disclosure Rules: The First Wave of SEC Comment Letters

were not fully aligned with current industry practice, led the SEC to reconsider its disclosure rules beginning in 2007. In December 2008, the SEC adopted new rules designed to modernize and update its oil and gas disclosure requirements to reflect current practices and changes in technology (see Modernization of Oil and Gas Reporting, SEC Release No. 33-8998 (Dec. 31, 2008)).

The new disclosure rules are set out in:
- Subpart 1200 of Regulation S-K under the Securities Act, which codified and superseded Guide 2 of the Securities Act Industry Guides.
- Rule 4-10 of Regulation S-X under the Securities Act.

Under the original disclosure rules, companies were prohibited from disclosing in their SEC filings any oil and gas reserves other than proved reserves. Under the new rules, companies must disclose their proved reserves and may, but are not required to, disclose their probable reserves and possible reserves. For definitions of proved, probable and possible reserves, see Box, Key Reserves-related Terms: Categories of Reserves.

The new five-year rule for PUDs and the rule permitting companies to prove their reserves using reliable technology are among the most significant changes affecting the way that companies disclose their proved reserves.

**FIVE-YEAR RULE FOR PUDS**

The five-year rule for PUDs is a time-based limitation on a company's ability to classify reserves as PUDs.

For PUDs to be booked for an undrilled location, the company must adopt a development plan indicating that the undrilled location is scheduled to be drilled within five years (see Regulation S-X, Rule 4-10(a)(31)). PUDs recorded on a company's books for more than five years should be removed from the proved reserves category.

The new rules include an exception to this hard five-year limit, however. PUDs may be booked for more than five years if the specific circumstances justify a longer interval before development is initiated. In Compliance & Disclosure Interpretations (C&DIs) issued by the SEC's Division of Corporation Finance in October 2009, the SEC staff identified examples of projects that may, depending on the situation, constitute the type of specific circumstances required to qualify for this exception. These include:
- Projects that involve the construction of offshore platforms.
- Developments in urban areas or remote or environmentally sensitive locations.

The C&DIs stress that it "should be the exception, and not the rule" for a company to classify a location as a PUD location even though development is scheduled to begin more than five years in the future (see C&DI 131.03).

For definitions of undeveloped and developed reserves, see Box, Key Reserves-related Terms: Undeveloped vs. Developed Reserves.

**USE OF RELIABLE TECHNOLOGY TO PROVE RESERVES**

Under the old disclosure rules, companies were generally confined to using flow tests or observing actual production to measure their reserves. To reflect the technological advances in the oil and gas industry over the past 30 years, the new rules permit companies to use reliable technology to make their determinations of proved reserves.

The new rules define reliable technology as technology that has been:
- Field tested.
- Demonstrated to provide reasonably certain results with consistency and repeatability in the formation being evaluated or in a similar formation.

(See Regulation S-X, Rule 4-10(a)(25).)

By defining reliable technology broadly, the SEC intended that companies may use their existing proprietary methods or develop new methods for determining their proved reserves.

**THE SEC COMMENT LETTERS**

Many of the comment letters issued by the SEC staff in 2010 and early 2011 addressed:
- The extent of companies' compliance with the five-year rule for PUDs.
- What constitutes sufficient support for booking new reserves that were added through the use of reliable technology.

In making these comments, it appears the goal of the SEC staff was to compel companies:
- To improve their disclosure on development plans for converting existing PUDs to proved developed reserves.
- To provide detailed descriptions of the specific technologies and methodologies employed where new proved reserves were added through reliable technology.

The SEC's comments on these two topics are discussed in detail below.

In light of these comments, companies should work to strike an appropriate balance between:
- Their concerns that too much disclosure could reveal sensitive proprietary information and harm their competitiveness.
- The goal of improving their disclosure under the five year rule and the reliable technology requirements to help avoid SEC comments on these topics in the future.

For a brief summary of some of the other issues raised in the SEC’s comment letters, see Other Topics Raised in the SEC Comment Letters.

For an overview of the purpose and process of the SEC’s review of companies' Exchange Act filings, including steps companies should take in response to SEC comment letters, see Practice Note, SEC Review of Periodic Reports (http://us.practicallaw.com/3-386-7134).
COMMENTS RELATING TO THE FIVE-YEAR RULE FOR PUDS

The SEC staff maintains a strong presumption against a company’s ability to maintain PUDs on its books for more than five years. This presumption is illustrated in the comment letters discussed below.

Concerns about the Rate of Conversion of PUDs

In several cases, the staff commented on descriptions of PUDs being converted to proved developed reserves at a rate that, mathematically, would take longer than five years. Where it did not appear possible for companies to convert all their existing PUDs to proved developed reserves within five years, the staff asked the companies to explain how they planned to accomplish the conversion within the required time period. In some cases the staff also asked companies to provide the amount and percentage of PUDs that had been converted to proved developed reserves in years before 2009. For examples of these types of comments, see the SEC comment letters to:
- Brigham Exploration Company (July 1, 2010).
- Petrohawk Energy Corporation (April 27, 2010).

The comment letters also highlighted cases where PUDs had been maintained on companies’ books for longer than five years, asking those companies to explain why those PUDs remained undeveloped. For some companies providing the requested explanations, the staff also asked when the companies planned to drill and produce from those locations. In these cases, the staff emphasized that if the companies were not reasonably certain of developing the wells within the next five years, the reserves estimates attributable to those locations should be removed from the category of proved reserves. For examples of these types of comments, see the SEC comment letters to:
- Range Resources Corporation (August 25, 2010).
- Nexen Inc. (July 2, 2010).
- Quicksilver Resources Inc. (July 2, 2010).
- Stone Energy Corporation (June 30, 2010).
- EOG Resources, Inc. (June 25, 2010).
- Cimarex Energy Co. (June 21, 2010).
- Encore Energy Partners LP (December 30, 2010).
- Rex Energy Corporation (Feb. 16, 2011).

In several cases the staff requested additional detailed information on how PUDs would be developed within the next five years (see, for example, SEC comment letter to EOG Resources, Inc. (June 25, 2010)).

Concerns about Development Schedules

For a company with significant PUDs attributable to a particular project, the staff requested additional information about the development schedule and other factors regarding the project (for example, whether there was one development project or multiple development projects and the terms of the relevant leases) (SEC comment letter to Devon Energy Corporation (June 11, 2010)).

Where a company had disclosed that it expected to drill 90% of its undrilled locations within the next five years, but there had been no material conversions in 2009, the staff requested expanded disclosure to:
- Clarify the company’s planned schedule for development of those reserves.
- Comply with the requirement to disclose investments and progress made during the year towards converting PUDs to proved developed reserves, including capital expenditures (see Securities Act Regulation S-K, Item 1203(c)).

(SEC comment letter to Stone Energy Corporation (June 30, 2010).)

Special Recovery Methods

If PUDs were expected to be developed and classified as proved developed reserves within five years due to special recovery methods, such as the use of compression techniques, the staff asked whether the company had made a final investment decision on installing the special recovery equipment and facilities in the field (SEC comment letter to Noble Energy, Inc. (December 10, 2010)).

Reasons for Delays

Where one company argued that certain PUDs could not be developed in five years because of factors largely out of its control, the staff disagreed, stating that the factors in question (a lack of access to hydraulic fracturing services, rental equipment and associated contract services) were known at the time the reserves were estimated. Accordingly, the staff concluded that the relevant PUDs should have been removed from the category of proved reserves (SEC comment letter to Swift Energy Company (February 16, 2011)).

Concerns about Liquidity

If it appeared that a company’s liquidity was insufficient to fund development plans, the staff asked for additional information explaining how the PUDs could be developed within the timeframe disclosed (see SEC comment letters to FieldPoint Petroleum Corporation (Mar. 2, 2011) and Mexco Energy Corporation (Mar. 9, 2011)).

Exception for Special Circumstances

Where a company had disclosed special circumstances to justify why certain PUDs would not be developed until year six or later, the staff asked for the total proved reserve figures for those particular PUD locations and the conditions that may prevent their initial development within five years of booking (SEC comment letter to EOG Resources, Inc. (June 25, 2010)).

Material Changes in PUDs

There were also several comments highlighting companies’ insufficient explanations of material changes in PUDs from year
Factors Behind Newly Added PUDs

Where additional PUDs had been added and the additions were attributable to several different factors, the staff requested disclosure on which portions of the additional PUDs were attributable to:

- Drilling.
- Acquisitions.
- Revisions.

(SEC comment letter to EOG Resources, Inc. (June 25, 2010).)

COMMENTS RELATING TO RELIABLE TECHNOLOGY

Under the new rules, to qualify as a reliable technology that may be used to make determinations of proved reserves, a technology must have been field tested and demonstrated to provide reasonably certain results with consistency and repeatability in the subject formation (see Use of Reliable Technology to Prove Reserves).

In several cases where additions to companies’ proved reserves estimates were based on the use of reliable technology, the staff requested specific descriptions of the technologies used to satisfy the required level of certainty for the reserves estimates. Specifically, the staff requested expanded disclosure on:

- The actual technologies employed.
- The reasons the companies believed those technologies were reliable in the geological environment in which they were applied.

The level of detail requested by the staff was referred to alternatively as a description, a general discussion and an explanation of the methods used. For examples of these types of comments, see the SEC comment letters to:

- Quicksilver Resources, Inc. (July 2, 2010).
- EOG Resources, Inc. (June 25, 2010).
- New Concept Energy, Inc. (April 19, 2010).

The staff also requested disclosure on the amount of proved reserves that were determined by using alternative methods and technologies, including production flow tests.

In at least one example, the staff found that a company’s broad, imprecise descriptions of the technologies it relied on did not meet the reasonable certainty threshold (see SEC comment letter to Brigham Exploration Company (July 1, 2010)).

Where references to the use of specific technologies were made, the staff sometimes requested explanation in greater detail (for example, additional disclosure regarding the microseismic operations and reservoir simulation modeling used by one company to estimate reserves) (see SEC comment letter to Rex Energy (January 27, 2011)).

OTHER TOPICS RAISED IN THE SEC COMMENT LETTERS

The SEC staff comments discussed above represent only a small portion of the types of oil and gas disclosure issues raised by the staff in their 2010 and early 2011 comment letters. Other issues raised include failure to provide adequate disclosure regarding:

- PUDs attributable to drilling locations not directly offsetting the producing well (see SEC comment letters to Petrohawk Energy Corporation (April 27, 2010), Petrohawk Energy Corporation (June 23, 2010), Brigham Exploration Company (July 1, 2010) and Brigham Exploration Company (September 1, 2010)).
- Fields that contained 15% or more of a company’s total proved reserves (see SEC comment letters to Cimarex Energy Co. (June 21, 2010) and Gulfport Energy Corporation (March 4, 2011)).
- The 12-month average pricing methodology (see SEC comment letters to Pyramid Oil Company (June 22, 2010) and Cimarex Energy Co. (June 21, 2010)).
- The extent to which the proved reserves are attributable to enhanced recovery techniques (SEC comment letter to QR Energy, LP (Oct. 27, 2010)).
- The effects of foreign taxes relating to oil and gas producing activities derived from proved oil and gas reserves (SEC comment letter to Kosmos Energy Ltd. (April 19, 2011)).
KEY RESERVES-RELATED TERMS
The following are summary definitions of key reserves-related terms used in this Article.

RESERVES
Reserves are estimated remaining quantities of oil and gas that are anticipated to be economically producible as of a given date by the application of development projects (see Regulation S-X, Rule 4-10(a)(26)). Sometimes proved reserves are referred to simply as reserves.

CATEGORIES OF RESERVES
Reserves must be categorized as proved, probable or possible.

Proved Reserves
Proved reserves are those quantities of oil and gas which, by analysis of geoscience and engineering data, can be estimated with reasonable certainty to be economically producible under existing economic conditions, operating methods and government regulations. For reserves to qualify as proved reserves, the operator must have commenced, or must be reasonably certain that it will commence, a development project to extract the hydrocarbons within a reasonable time (see Regulation S-X, Rule 4-10(a)(22)). Proved reserves are sometimes referred to as reserves.

Probable Reserves
Probable reserves are reserves that are less certain to be recovered than proved reserves but which, in sum with proved reserves, are as likely as not to be recovered (see Regulation S-X, Rule 4-10(a)(18)). Under the new rules companies may, but are not required to, disclose probable reserves.

Possible Reserves
Possible reserves are reserves that are less certain to be recovered than probable reserves (see Regulation S-X, Rule 4-10(a)(17)). Under the new rules companies may, but are not required to, disclose possible reserves.

UNDEVELOPED VS. DEVELOPED RESERVES
Whether categorized as proved, probable or possible, reserves are further classified as developed or undeveloped in line with the definitions set out below.

Undeveloped Reserves
Undeveloped reserves are reserves in any of the three categories listed above that are expected to be recovered from either:

- New wells on undeveloped acreage.
- Existing wells where a relatively major expenditure is required before the reserves may be recovered.

(See Regulation S-X, Rule 4-10(a)(31).)

Developed Reserves
Developed reserves are reserves in any of the three categories listed above that are expected to be recovered both:

- Through existing wells with existing equipment and operating methods (or otherwise where the cost of the required equipment is relatively minor compared to the cost of a new well).
- If extraction will be done through means not involving a well, through extraction equipment and infrastructure that is installed and operational at the time of the reserves estimate.

(See Regulation S-X, Rule 4-10(a)(6).)