



Update – New SEC Oil and Gas Reserves Rules Raising Issues

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When the SEC finalized its new oil and gas disclosure rules for effectiveness commencing December 31 of this year, many hailed the new oil and gas reserves definitions as being much more in line with industry standard reserve categories. It was initially widely believed that the SEC's revised definition of proved reserves would justify labeling substantial additional oil and gas volumes from future development wells as "proved," the gold standard of oil and gas reserve categories.

While some aspects of the new proved reserves definition may indeed be liberating, it appears the enthusiasm for booking substantial additional proved undeveloped reserves, or PUDs, under the new SEC definitions has waned somewhat in light of recent SEC staff interpretations and statements. PUDs typically represent proved reserve estimates from development wells to be drilled on future drilling locations. The most significant limiting interpretation the SEC staff is pressing is a hard-to-rebut restriction on recognizing PUDs scheduled for drilling more than five years from the date of original booking. In fact, many are now concerned about the potential under the new definitions for significant write-offs of previously booked PUDs. New pricing rules effective for 2009 year-end SEC reserves may also limit reserve additions.

Following the SEC's October 26, 2009 release of compliance and disclosure interpretations on the proposed oil and gas rules, informal discussions with the SEC staff have shed more light on the SEC's view of this more limiting five-year development policy for proved undeveloped reserves under the new rules. *Unless the SEC backs down, the bottom line is that, with very limited exceptions, any PUD wells scheduled for drilling more than five years from the original date reserves were booked as proved for that well, including reserves presently booked, are subject to being reduced to non-proved status, or effectively written off.* There also is no grandfathering – that is, if the PUDs have been on the books for more than five years or are being pushed for scheduled drilling beyond five years from the original booking date, they are suspect.

The "specific circumstances" considered for possible limited exceptions to this five-year development horizon, as detailed in the October 26, 2009 interpretive release, focus primarily on demonstrating a consistent historical track record of development and capital spending, with delays justified only by external influences. So far, the only such projects the SEC has specifically identified as potential candidates for delayed proved development are those involving construction of offshore platforms and development in urban areas, remote locations, or environmentally sensitive locations.



To our knowledge, the SEC staff has not clarified the circumstances and timing under which PUDs that have been debooked, due to application of this five-year rule or otherwise, may be added back to future reports as PUDs. The only informal staff comment on this topic of which we are aware addresses PUDs removed due to pricing economics, which reserves reportedly may be added back when prices and economics improve, presumably with a reset five-year development clock.

We are stressing in financial analysis, due diligence, and disclosure for oil and gas companies that consideration be given to the potential for write-offs of booked PUDs under these new definitions and interpretations and the impact that could have on the company. In the event such a write-off of proved reserves were to occur, these write-offs could affect property impairment or ceiling test write-downs. Borrowing base determinations under oil and gas credit facilities may also be adversely affected, unless banks revise their borrowing base models to include reserves that lose SEC proved status as a result of application of new rule definitions and interpretations. Companies may also consider evaluating currently booked reserves to identify PUDs that are likely in future reports to have scheduled drilling dates pushed beyond the five-year anniversary of original PUD designation. Some have suggested consideration of the conservative choice of debooking those now, while the financial community may be more understanding of the effects of the rule change.

It is expected that the SEC staff will clarify that undeveloped oil and gas reserves that may have been categorized as proved, but for the five-year development limitation may be categorized as probable reserves under the new SEC definitions. This is not apparent from the wording of the new definitions. If confirmed, this may encourage some reporting companies to include probable reserves as optional disclosure in SEC filings to quantify those previously booked or potential PUDs that are scheduled for drilling more than five years from booking date. If any probable reserves disclosure is being contemplated for SEC filings, consideration should be given to commissioning an independently engineered reserve report covering both proved and probable reserves in compliance with the SEC definitions and interpretations in order to satisfy future underwriter comfort requirements and to further protect the company and its directors.

Two other uncertainties in the new SEC definitions and interpretations may be causes of concern. First, the October 26, 2009 interpretive release emphasizes that adoption of a development plan to book specific reserves “requires a final investment decision.” This is difficult to apply literally – capital expenditure decisions are made upon spending or contractual commitment, not in the planning phase, and are often subject to revision. This interpretation may cause some companies and engineering firms to require more evidence of commitment to pursue a specific PUD development plan, or to impose limits on the scope of a plan. Availability of capital and financing may also act to limit aggressive development plans. We suspect that bookings of proved reserves based on development plans with unusually large increases in capital expenditure levels will be subject to higher scrutiny, either by the SEC or outside engineering firms.

In addition, the SEC has done little to date to clarify what is needed to demonstrate “reliable technology” used to justify booking PUDs. This uncertainty could fuel initial conservatism



among companies and engineering firms in booking under the new definitions additional PUD well locations that are not adjacent to, or with horizontal laterals extending long distances from, producing wells.

Perhaps the biggest impact of the new SEC reserve rules is the requirement that year-end SEC reserves must be calculated using an unweighted average of 12-month first day of the month oil and gas pricing, as opposed to end of the year pricing under old rules. Due to significantly depressed prices earlier in 2009, the 12-month average benchmark prices to be used in 2009 year-end reserve reports are approximately \$57.65 per barrel of oil for West Texas Intermediate (Plains posted) and \$3.87 per mmBtu of natural gas for Henry Hub spot. These average prices compare to today's 2009 year-end prices of \$75.75 per barrel and \$5.79 per mmBtu that would have been the applicable SEC reserves pricing if the old rules continued in effect for this year-end. These differences may have a substantial impact on the marginal economics of booking year-end reserves and reserve values. Under the new rules, companies may consider supplementing required reserves disclosures in SEC filings with optional disclosure of reserves determined with alternative pricing, including possibly using pricing as of this year-end.

The combination of foregoing issues and concerns may significantly dampen the prospects for significant additional proved reserve bookings at year-end 2009 resulting from the new definitions. In public disclosures and filings, consideration should be given to disclosure of any material impact the new rules may have on year-end 2009 proved reserves and the collateral effects on borrowing base determinations, impairments, depletion rates, and finding costs.

Companies may also need to examine for possible revision their current nomenclature for non-proved hydrocarbon quantities to the extent publicly disclosed in investor presentations or press releases. "Probable" and "possible" reserves have now been given specific meaning by the SEC, and the SEC has declared non-reserve resources as too speculative for inclusion in SEC filings. Items for examination include whether current nomenclature for non-proved hydrocarbon volumes is sufficiently defined, including its risk of recovery; who determined it; what standard, if any, it complies with; and whether or not it comports with SEC probable or possible reserves definitions using pricing based upon the new 12-month historical average, which is applicable to all SEC-defined reserves categories.

This Energy Currents E-communication updates our prior E-communication, "[SEC Modernizes Oil and Gas Disclosure Rules](#)." For more information about these topics, please contact Vinson & Elkins lawyers [Mark Kelly](#), [Alan Baden](#), or [James Prince](#). Visit our website to learn more about Vinson & Elkins' [Energy, Capital Markets and Securities](#), and [Securities Litigation and Enforcement](#) practices.

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