



New world of disclosure for energy companies?

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In many ways, the first half of 2010 has been a perfect storm for companies in the business of exploring for and producing hydrocarbons. Public concern regarding the environmental, health and safety risks inherent in those businesses has skyrocketed, with daily headlines reinforcing the reality of those risks.

2010 was already poised to be a year of significant change for energy companies. Media attention (not all positive) on the use of hydraulic fracturing to extract previously inaccessible natural gas from shale formations has been increasing, and the SEC announced interpretive guidance on climate change. Then, in the beginning of the second quarter, the Macondo well in the Gulf of Mexico blew out and the Deepwater Horizon rig sank.

Legislative and regulatory actions have only just begun at the federal, state and local levels to address a now even more heightened concern over the breadth and depth of the risks resulting from energy company operations. Critics of deepwater operations have quickly linked concerns regard-

ing deepwater exploration, drilling and production with the inherent riskiness of *all* oil and gas industry activities, including those taking place in shallow waters as well as onshore.

The recent explosion on a second offshore installation in the Gulf of Mexico added to these concerns. In this environment, energy companies must recognize that the disclosure in their SEC reports is now subject to even greater scrutiny. Investors, regulators, activists and the plaintiffs' bar will examine and question with the benefit of hindsight companies' descriptions of their liquidity, key business risks, future business prospects and strategies, as well as the anticipated impact of regulatory and legislative changes.

A question that each of these groups will ask – in one form or another – of every publicly traded energy company is, “How does your disclosure take into account the changes affecting your industry?”

This article's purpose is to help companies answer this question by first examining how and why regulatory and industry-wide changes are impacting the disclosure of energy

companies. Second, it identifies key aspects of energy company disclosure that require review in light of these changes.

What has changed and how does it impact disclosure?

The SEC's climate change guidance

In February 2010, the SEC issued an interpretive release regarding climate change disclosures. As some observers noted, though this release was labeled interpretive and ostensibly intended only to reaffirm and emphasize existing regulations, the fact that the SEC issued this release clearly signaled its interest in environmental disclosure. A closing remark in this release underscored this point when the SEC said that it would monitor the effects of its guidance on public company disclosure and consider whether more guidance or rulemaking is required.

Additional regulatory scrutiny

In addition to causing a moratorium on deepwater drilling in the Gulf of Mexico, the Macondo well blowout highlighted operational, contractual and a host of other risks related to the oil and gas industry. Many regulatory changes, particularly related to drilling, have already come swiftly.

For example, the Obama administration recently

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announced a ban on the use of “categorical exemptions” for deepwater drilling activities. The administration also announced that shallow water drilling activities would be subject to enhanced environmental reviews. While these actions may not have a significant impact yet on deepwater drilling in light of the current moratorium on it, once the moratorium is lifted, these regulations will subject the oil and gas industry to project delays and increased costs going forward.

As a recent article in the *New York Times* noted, “[t]he more stringent environmental reviews are part of a wave of new regulation and legislation that promises to fundamentally remake an industry that has operated hand-in-glove with its government overseers for decades.”

While opinions differ as to whether energy companies have been adequately regulated in the past, the understanding that the industry is undergoing a “fundamental” and seismic change is widespread and widely reported in the media. Therefore regulators, market participants and others will expect disclosure by energy companies of their business condition and prospects to reflect this rapidly changing business environment.

What is likely to change in the public company reporting practices of energy companies?

Taking into account both the issues discussed in the SEC’s climate change interpretive release as well as recent SEC comment letters to energy companies, companies must confirm that their disclosure appropriately reflects the current economic, industry specific, and legislative and regulatory environment. The following are some areas of disclosure that should be reexamined.

Description of business

Energy companies should consider how the Macondo well blowout and its aftermath affect their businesses. For example:

- If a company has significant operations in the Gulf of Mexico, has the company’s business plan changed in light of the moratorium and the expectation of more regulation of U.S. offshore operations?
- Does the company expect more regulation of offshore operations internationally also and how will these regulations affect its business?
- Has the expectation of this regulation caused the company to announce a reallocation of its asset portfolio more towards onshore or international assets?
- How are risks among the company, its partners, customers and service providers allocated contractually?
- Has the availability of insurance for the company’s operations changed?

Each company should consider whether the historical description of its businesses continues to be an accurate description of its businesses now. In addition, and to the extent that it has already publicly disclosed planned divestments or other material changes to its businesses, company executives should look at the firm’s future profile.

A company should also consider whether industry changes may make it more dependent on smaller numbers of customers or suppliers and how these changes will affect its competitive position. Each company will also need to describe how its capital expenditures, earnings and competitive position may be affected by more stringent environmental rules, including pursuant to any greenhouse gas emissions regulations, if they are adopted.

Management’s discussion and analysis

The SEC has repeatedly stated that management’s discussion and analysis (MD&A) should help investors see a company and its prospects “through the eyes of management.” An interpretive release on MD&A issued by the SEC over two decades ago underscored the importance of expanding MD&A beyond historical results of operations when it noted that MD&A is intended to have a “particular emphasis on the registrant’s prospects for the future.” Therefore, companies must reassess their forward-looking disclosure in light of climate change considerations and the aftershocks from the Macondo well blowout.

For example, companies with significant deepwater operations should reflect on the financial and commercial

consequences of the deepwater drilling moratorium on their businesses and those of key customers and suppliers. In doing so, they should consider whether the delays and higher costs resulting from the additional environmental reviews to be conducted by the government prior to granting deepwater drilling permits will be material to them. In addition, exploration and production companies need to consider the impacts of new or pending regulations on their ability to grow reserves at their historical growth rates.

Drilling and other service companies should not only consider the impacts on their ability to service clients in the Gulf of Mexico, but also whether deploying rigs and other vessels to other areas of the world might mitigate these impacts. All energy companies should consider how complying with new regulations will impact their future capital expenditures.

It is also noteworthy that the SEC's climate change interpretive release includes examples of how possible regulation of greenhouse gas emissions might affect the businesses of energy companies. Companies need to consider the likelihood of the adoption of such regulations and whether, if adopted, they will have a material impact on them.

Additionally, MD&A must describe, from management's perspective, not only a company's risks but also its opportunities. For example, a drilling equipment manufacturer that believes that it could benefit from the adoption of contemplated regulations requiring drilling companies to maintain redundant equipment as backup should describe this opportunity, if it believes that it is material to its business.

This final point is important because of all of the uncertainty currently surrounding the oil and gas industry. The SEC has repeatedly stated that uncertainty as to whether particular risks or opportunities will materialize that could be material does not excuse the failure to disclose them now. Instead, the SEC requires management to assume that the risks or opportunities will occur and then to disclose both them and their impact "unless management determines that a material effect on the [company's] financial condition or results of operations is not reasonably likely to occur."

Companies should remember both the maxim that "hindsight is 20/20" as well as the SEC's explicit warning that, where a material change occurs in the financial statements and "the likelihood of such change was not discussed in prior reports, the [SEC]...will inquire as to the circumstances existing at the time of the earlier filings to determine whether the registrant failed to discuss [the information that should have been disclosed in MD&A]."

Risk factors

Another important area for carefully rethinking energy company disclosure is risk factors. Risk factors provide readers of disclosures in SEC reports with an understanding of a company's key risks. Recently, the SEC appears to have a renewed and active interest in this area of disclosure. Moreover, appropriate disclosure of key risks can help a company in securities litigation if it can establish that it adequately warned investors of the riskiness of their investment in the company.

In addition to filings made with it, the SEC reviews company websites, press releases, trade publications and other sources of information to understand an industry and the companies in it. The SEC may question the adequacy of disclosure because of these other sources of information. For example, if members of the SEC staff read an article regarding the increasing difficulty of insuring offshore operations, in reviewing the Form 10-K of a deepwater exploration and production or service company they will look for disclosure on this point. Companies with offshore operations must either have provided appropriate disclosure in their SEC filings or be ready to explain why they are not materially impacted by this issue.

Litigation and financial statement reserves

The proposed removal of liability caps under the Oil Pollution Act combined with the prospect for the adoption of a more stringent accounting rule for contingent losses could significantly impact financial statement disclosure for energy companies. If adopted, the proposed accounting rule would require disclosure of a contingent liability even if the probability of loss is remote so long as the loss could have a "potential severe impact."

Energy companies must carefully monitor their operational risk, exposure to litigation and accounting rulemaking so that their financial reporting appropriately reflects current developments in all three areas.

New disclosure obligations

New regulations and legislation not related to events in the Gulf of Mexico may create new disclosure obligations. For example, the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act includes a provision requiring U.S. energy companies to disclose payments made to foreign governments for the commercial development of oil and natural gas fields.

Conclusion

Time will confirm the accuracy of current forecasts of radical and lasting change in the oil and gas industry. However, it is clear that the industry is undergoing an important transition period in which environmental, health, safety and economic considerations, among others, will shape the energy industry of the future. Among the challenges facing publicly traded energy companies today is updating their disclosures so that they reflect the factors that currently or may in the future materially impact their businesses. **OGFJ**

About the author

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