

September 7, 2011

SEC ASKING MORE QUESTIONS ABOUT HYDRAULIC FRACTURING

The SEC has joined the ranks of federal and state legislators and regulators in taking a closer look at hydraulic fracturing, a process used widely by oil and gas companies to enhance their drilling and extraction of natural gas and oil. The SEC's enhanced interest in this subject has manifested itself, thus far at least, through comments made during SEC staff reviews of registration statements and other filings by public companies. This advisory discusses some of the areas of comment by the SEC's staff and reviews SEC disclosure rules that may be applicable to companies engaged in hydraulic fracturing.

BACKGROUND

Hydraulic fracturing, or "fracking," is a technique used to increase the volume of natural gas and oil that can be recovered from underground reserves. Although it has been used for many years in a variety of rock formations for both oil and natural gas recovery, in the past few years expanded use of hydraulic fracturing has contributed to a large increase in production of natural gas from tight shale formations.¹ Hydraulic fracturing usually involves pumping fracking fluid, which is composed of water, sand, and a small amount of chemicals, under high pressure into the rock formation to create fissures, or fractures, thereby enabling natural gas and oil trapped within the formation to escape and flow to the surface.

As the use of hydraulic fracturing has expanded in recent years, particularly into shale formations under populous areas (such as the Marcellus shale play in the northeast United States), public concern has grown over its possible effects on the environment, including on drinking water supplies. More specifically, some have expressed concern that chemicals in the fracking fluid could migrate to water aquifers, or that the pressure from the fracking process could cause fracking fluids or natural gas to leak from well casings and contaminate water supplies. Concerns have also been voiced with respect to "flowback" - contaminated waste water from fracking that flows back to the surface and is typically stored in containment ponds or tanks before being disposed of. Despite these concerns, the available scientific evidence does not suggest that properly conducted hydraulic fracturing poses a meaningful risk to water supplies.²

¹ Improved horizontal drilling methods and other technological enhancements have also contributed to this increase. See Ninety-Day Report, The SEAB Shale Gas Production Subcommittee, Secretary of Energy Advisory Board, U.S. Department of Energy (Aug. 11, 2011) ("DOE Report").

² Industry proponents of the safety of fracking cite studies performed by the Ground Water Protection Council, an association of state regulators, as well as a 2004 study by the U.S. Environmental Protection Agency ("EPA") of the effects of hydraulic fracturing on coalbed methane reservoirs. See, e.g., State Oil and Natural Gas Regulations Designed to Protect Water Resources, prepared by Ground Water Protection Council for the U.S. Department of Energy ("DOE"), Office of Fossil Energy, Oil and Natural Gas Program (May 2009); Evaluation of Impacts to Underground Sources of Drinking Water by Hydraulic Fracturing of Coalbed Methane Reservoirs,

FEDERAL AND STATE REGULATION

Currently, regulation of hydraulic fracturing activities is largely left to state and local governments. This is because the Safe Drinking Water Act of 1974 (“SDWA”) excludes from its purview the underground injection of fluids or propping agents (other than diesel fuels) pursuant to hydraulic fracturing operations related to oil or gas production.³ Public disclosure of some chemicals used in the fracking process is required under existing federal statutes, but these laws are limited in their scope.⁴ Although legislation has been introduced in Congress in recent sessions to provide for greater federal regulation of hydraulic fracturing (including requiring disclosure of chemicals used in the fracking process), to date no such bills have been enacted.⁵

Despite the limited mandate given to the federal government under the SDWA, federal regulators have begun to assert more of a role in overseeing fracking activities. In March 2010, the EPA announced plans to commence a study of the potential impacts of hydraulic fracturing on drinking water and groundwater, with initial research results anticipated to be available by late 2012 and a final report by 2014.⁶ The EPA also recently announced that it will develop permitting guidance for hydraulic fracturing activities that use diesel fuels in fracking fluids.⁷ In addition, the DOE has been charged by President Obama with providing recommendations to improve the safety and environmental performance of fracking. The DOE’s initial report under this directive makes a number of recommendations, including requiring public disclosure of all chemicals contained in fracking fluids, with an exception for genuinely proprietary information.⁸

At the state level, there have been a variety of recent regulatory and investigatory initiatives regarding hydraulic fracturing. Some states have adopted, and other states are considering, regulations imposing more stringent permitting, disclosure, and/or well location or construction

U.S. Environmental Protection Agency (Jun. 2004); Survey Results on Inventory and Extent of Hydraulic Fracturing in Coalbed Methane Wells in the Producing States, Ground Water Protection Council (Dec. 1998).

³ See §1421(d)(1)(B)(ii) of the 2005 Energy Policy Act, amending the SDWA.

⁴ For example, under the Emergency Planning and Community Right to Know Act, facilities that store specified quantities of designated hazardous chemicals must make Material Safety Data Sheets regarding such chemicals available to the public, and the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 requires public disclosure of the release of specified hazardous chemicals into the environment.

⁵ Some of the Democratic members of the Energy and Commerce Committee of the U.S. House of Representatives have also been conducting an investigation of hydraulic fracturing practices. Their staff released a report in April 2011 regarding chemicals used in the fracking process. See Report of the Minority Staff, Chemicals Used in Hydraulic Fracturing, Energy and Commerce Committee, U.S. House of Representatives (Apr. 2011).

⁶ Press Release, “EPA Initiates Hydraulic Fracturing Study: Agency seeks input from Science Advisory Board” (Mar. 18, 2011). The EPA’s draft study plan is available on the EPA’s website at http://water.epa.gov/type/groundwater/uic/class2/hydraulicfracturing/upload/HFStudyPlanDraft_SAB_020711-08.pdf.

⁷ The EPA has stated that it has authority to develop such guidance under the Underground Injection Control provisions of the SDWA. See §1421(d)(1)(B)(ii) of the 2005 Energy Policy Act.

⁸ DOE Report at 3. While endorsing public disclosure of the chemicals used in fracking fluids, the DOE Report notes that the risk of fracking fluid leakage into drinking water sources through fractures in deep shale formations is remote.

requirements on hydraulic fracturing operations. For example, Arkansas, Pennsylvania, Colorado, Wyoming, and Texas each have adopted various regulations addressing, among other things, well construction and location, fracking operations, or disclosure of the composition of fracking fluids.⁹ Other states have undertaken efforts to prohibit hydraulic fracturing altogether. For example, the governor of New Jersey recently vetoed a bill that would have permanently banned hydraulic fracturing in New Jersey, but he proposed a one-year moratorium on fracking operations in the state instead.¹⁰ States have also begun using their enforcement powers in this area; in New York, it has been reported that the Attorney General recently sent subpoenas to several large oil and gas companies seeking information regarding the accuracy of such companies' public disclosures regarding environmental risks arising from their fracking operations.¹¹

SHAREHOLDER PROPOSALS

In addition to recent increased legislative and regulatory activity, shareholder activist groups have been stepping up pressure on public oil and gas companies to provide more disclosure about their fracking activities. Shareholder proposals were submitted to a number of public oil and gas companies in 2010 and 2011 calling for reports regarding the environmental impact of the company's fracking operations and potential policies that could be adopted to reduce or eliminate hazards to the environment.¹² Some industry participants have agreed to voluntarily disclose information about the chemicals used in their fracking fluids on a public interest website containing a database of chemicals used in the fracking of a large number of wells.¹³

RECENT SEC STAFF COMMENTS

Although its jurisdiction in this area is not as obvious as the EPA's at first glance, the SEC's Division of Corporation Finance is showing elevated interest in hydraulic fracturing, based on comments made during staff reviews of registration statements and other filings with the SEC by companies in the oil and gas business. Thus far, the staff has not issued any formal directive or guidance on the subject, and it is not clear whether the staff's comments might lead to formal interpretive guidance

⁹ See, e.g., General Rule B-19 in Ark. Oil & Nat. Gas Comm. Gen. R. & Reg. (regarding well completions using fracture stimulation); 25 Pa. Code §§ 78.71 to 78.125 (LexisNexis 2011); Rule 205 (inventory chemicals), Rule 317 (well casing and cementing), and Rule 906 (spills and releases) adopted by the Colorado Oil and Gas Conservation Commission; Wyo. R. & Reg., chap. 4, § 10; and Tx. Ann. Natural Resources, §91.851 (LexisNexis 2011).

¹⁰ Press Release, "Governor Chris Christie Stands Up for Sound Policymaking By Issuing One-Year Moratorium on Fracking" (Aug. 25, 2011), *avail. at* <http://www.state.nj.us/governor/news/news/552011/approved/20110825c.html>; Letter from Governor Chris Christie to New Jersey Senate regarding Senate Bill No. 2576 (Aug. 25, 2011).

¹¹ Ian Urbina, *New York Subpoenas Energy Firms*, N.Y. Times (Aug. 18, 2011).

¹² According to the Investor Environmental Health Network, none of these proposals was approved, but some received a significant percentage of votes in favor; others were withdrawn in light of commitments made by the company. Copies of a number of the shareholder proposals are available at <http://www.iehn.org/resolutions.shareholder.php>.

¹³ The website, <http://fracfocus.org/>, is a joint project of the Ground Water Protection Council and the Interstate Oil and Gas Compact Commission.

or even rulemaking in the future.¹⁴ For now, the staff appears to be making comments seeking specific disclosures within the existing framework of the SEC's disclosure rules applicable to all public companies, such as those calling for a discussion of material risk factors. However, in light of the staff's recent trend of comments in this area, companies engaged in hydraulic fracturing should probably expect to be asked about their fracking activities and related disclosures when undergoing a review by the SEC staff. Moreover, even before a staff review, oil and gas companies would be well-advised to consider whether, and how, to address disclosure issues regarding their hydraulic fracturing activities.

Though the following list is not meant to be exhaustive, in recent comment letters the SEC staff has made the following requests:

- expanded disclosure of the company's use of hydraulic fracturing, including identifying the locations where it is used and acreage or reserves with which hydraulic fracturing is associated;
- disclosure of whether the company has been cited, found in violation of, or sued for issues relating to the company's hydraulic fracturing operations (including the circumstances of any such actions, the company's response, and penalties assessed);
- expanded discussion of risks related to possible changes in applicable laws related to hydraulic fracturing;
- disclosure of the costs and funding associated with hydraulic fracturing operations;
- disclosure regarding the steps the company has taken to minimize potential environmental impacts from its hydraulic fracturing operations;
- disclosure of contractual provisions that might subject the company to environmental-related damages or that would indemnify the company for such amounts, and risks for which the company is insured, related to its hydraulic fracturing operations;
- identifying for the staff chemicals used in the company's fracking fluid; and
- providing the staff with information regarding the amount of water used in the hydraulic fracturing process.

When responding to comments such as the ones noted above, it is reasonable for companies to analyze the requested disclosures under traditional materiality considerations and in the context of specific SEC disclosure rules that might be relevant, as discussed below. These materiality considerations might include, for example, the nature of the company's business (e.g., whether the company is an operator or a drilling service provider), the relative importance of hydraulic fracturing to the company's operations and results, the geographic focus of the company's operations, and any actual environmental proceedings or regulatory actions.

Assessing the potential materiality of known uncertainties is a matter of judgment, and when analyzed using the twin variables of potential magnitude and probability, certainly some companies could reasonably conclude that some of the staff's requests for disclosure would not pass the "materiality" threshold. For example, it is not clear why disclosure of the steps a company has taken to minimize the environmental impact of its hydraulic fracturing activities would be material to an investor, absent actual, pending or reasonably anticipated lawsuits or governmental enforcement actions based on such activities.

¹⁴ Some of the staff's comments in this area echo some of the guidance published by the SEC in 2010 regarding disclosure related to climate change. See Commission Guidance Regarding Disclosure Related to Climate Change, Rel. No. 33-9106 (Feb. 2, 2010) ("Climate Change Guidance Release").

Stepping back from the various specific comments, a central theme of the staff's comments appears to be to encourage early disclosure of what might *potentially* be a future significant contingency, even well before the scientific, regulatory, and political landscape has evolved sufficiently to give real clarity on the scope or nature of that potential contingency. The staff's comments seem to be premised on the view that it is prudent to tell investors as much as possible about hydraulic fracturing now, on the theory that, one day, a company might be exposed to material contingencies or losses associated with its fracking activities.

From a practical standpoint, for each company the nature and timing of the staff's review will likely impact the company's response. For example, a company responding to a comment letter in a review of its annual report on Form 10-K may have more time and flexibility to debate the materiality or usefulness of additional disclosure suggested by SEC comments, whereas companies seeking to clear a registration statement for a pending securities offering may be under real pressure to give the staff what it is asking for in order to complete the pending transaction.

Finally, companies responding to staff comments such as those noted above may wish to consider seeking confidential treatment for certain of their responses, to the extent the information requested is proprietary or its public disclosure would cause the company competitive harm.¹⁵

POTENTIALLY APPLICABLE SEC DISCLOSURE RULES

Whether or not responding to SEC comments, public companies engaged in hydraulic fracturing should consider whether, and how, hydraulic fracturing might be a relevant subject to address in response to several line items under the SEC's disclosure regime. Of course, there is no line item specifically calling for disclosure about hydraulic fracturing. Nevertheless, the following items may call for disclosure regarding hydraulic fracturing, depending on materiality considerations as discussed above.

Risk Factors (Item 503(c))

Item 503(c) of Regulation S-K requires, where appropriate, a discussion of the most significant factors that make an investment in the company speculative or risky. Item 503(c) specifies that risk factor disclosure should clearly state the risk and specify how the particular risk affects the particular company.

Many companies in the oil and gas business have begun to include risk factor discussion regarding hydraulic fracturing. In most cases, the risks identified focus on the possibility that new laws or regulations could be enacted that might restrict or otherwise regulate hydraulic fracturing. The potential effects of such new legislation or regulation could range from limiting or even prohibiting hydraulic fracturing in certain states or areas, to new permitting requirements or operational restrictions, which in turn could result in increases in operating costs. Some companies have also noted that there is a risk that new restrictions, including moratoriums, imposed by legislation or regulation could reduce the amount of natural gas or oil that may be recoverable. There might also be a risk of increased private litigation or governmental investigations or enforcement based on environmental claims.

¹⁵ In the context of correspondence as part of a staff review, the likely avenue for seeking confidential treatment is SEC Rule 83 (17 C.F.R. 200.83). Companies may also request the return of materials submitted supplementally to the staff pursuant to Rules 12b-4 under the Securities Exchange Act of 1934 and/or Rule 418(b) under the Securities Act of 1933, but this, alone, does not protect the information from a FOIA request during the period the information is held by the staff.

Management's Discussion and Analysis (Item 303)

In MD&A, companies are required to identify and disclose known trends, events, demands, commitments, and uncertainties that are reasonably likely to have a material effect on the company.¹⁶ This disclosure is intended to highlight issues that are reasonably likely to cause reported financial information not to be necessarily indicative of future operating performance or of future financial condition.

With regard to hydraulic fracturing, companies may wish to consider, for example, whether uncertainties regarding future legislative or regulatory restrictions merit discussion in the MD&A, in light of materiality considerations relevant to the company. Legislative or regulatory restrictions, including moratoriums, could, for example, reduce quantities of recoverable natural gas or oil. As the regulatory picture evolves, companies may also wish to consider whether the discussion of anticipated capital expenditures should take into account costs (or known uncertainties regarding such costs) for hydraulic fracturing or compliance with applicable laws and regulations.

Description of Business (Item 101)

In addition to requiring a description of the material aspects of a company's business, Item 101 of Regulation S-K requires disclosure regarding certain costs of complying with environmental laws.¹⁷ Although such costs related to hydraulic fracturing may not be material under current laws and regulations in most cases, companies will need to review applicable regulatory requirements and consider whether disclosure might be warranted, including in the future in light of applicable future laws and regulations.

Legal Proceedings (Item 103)

Item 103 of Regulation S-K requires a company to briefly describe any material pending legal proceeding to which it or any of its subsidiaries is a party or in which its property is the subject of the litigation. Instruction 5 to Item 103 provides some specific requirements that apply to disclosure of certain environmental litigation.¹⁸ Companies will need to assess whether any such proceeding (private or public) related to its hydraulic fracturing activities meets the criteria for disclosure under Item 103.

¹⁶ See, e.g., Modernization of Oil and Gas Reporting, Rel. No. 33-8995 (Dec. 31, 2008) at 85-88; Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Rel. No. 33-8850 (Dec. 19, 2003). See also Climate Change Guidance Release.

¹⁷ Item 101(c)(1)(xii) states that "[a]ppropriate disclosure also shall be made as to the material effects that compliance with federal, state and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries. The registrant shall disclose any material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year and its succeeding fiscal year and for such further periods as the registrant may deem material."

¹⁸ Instruction 5 requires the disclosure of administrative or judicial proceedings arising under environmental protection statutes if (a) such proceeding is material to the business or financial condition of the registrant, (b) such proceeding involves damages or other payments or charges exceeding 10 percent of the registrant's current assets, or (c) a governmental authority is a party to such proceeding and such proceeding involves potential monetary sanctions, unless the registrant reasonably believes that such proceeding will result in no monetary sanctions, or in monetary sanctions of less than \$100,000.

Other Considerations

Although the SEC staff has, at least in some cases, asked companies to tell the staff of the chemicals it uses in its fracking fluids, disclosure of such chemicals in the context of a registration statement or other filing with the SEC does not seem to be required under the SEC's disclosure rules, at least in the context of the current federal and state regulatory regime relating to hydraulic fracturing. It is difficult to see, absent unusual circumstances, how disclosure of specific chemicals would be material to an investor, or how such disclosure would be responsive to the SEC disclosure items noted above. With that said, as the state and federal regulatory picture evolves over time, it is possible that such information could become more relevant and/or potentially responsive to one of the disclosure items noted above.¹⁹

While many will rightly question the materiality of some of the staff's requested disclosures, it is also possible that some companies decide that affirmative, fulsome disclosure regarding their hydraulic fracturing activities will allow them to get out in front of the story, and to put the risks related to fracking in an appropriate context. For example, while there is no affirmative duty to disclose that the company is not party to any legal proceedings if that is the case, some companies may choose to affirmatively state that there are no such proceedings related to the company's hydraulic fracturing activities. In any event, as the federal and state regulatory regime continues to evolve, companies engaged in hydraulic fracturing will need to stay abreast of such developments and modulate disclosures in their SEC filings accordingly.

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¹⁹ Further, as noted above, many states have enacted, or are considering enacting, requirements to publicly disclose such chemicals.