

SEC Proposes Modernizing Oil and Gas Reporting Requirements

The Securities and Exchange Commission (“SEC” or “Commission”) recently proposed revisions to Regulations S-X and S-K in an effort to align oil and gas reporting requirements with current practices.¹ The proposal is in response to the significant technological advances, and changes in the types of projects in which oil and gas companies invest their capital, that have taken place since the existing rules were adopted three decades ago.² Comments on the proposed rules are due by September 8, 2008.

The proposed revisions would address three significant issues:

- The limitation in the current rules that permits oil and gas companies to disclose only their proved reserves;
- The limitations regarding the types of technologies that oil and gas companies may rely upon to establish the levels of certainty required to classify reserves; and
- The exclusion of activities related to the extraction of bitumen and other “non-traditional” resources from the definition of oil and gas producing activities.

The proposed revisions would also change the pricing method for reserve calculation purposes, and revise and add definitions to assist in determining economic producibility of oil and gas reserves.³

I. PROPOSED REVISIONS TO RULE 4-10 OF REGULATION S-X

Disclosure of probable and possible reserve estimates.

The SEC proposes to allow voluntary disclosure in filings under the Securities Exchange Act of 1934 of probable and possible reserves. Such disclosure is currently prohibited. The proposed permitted disclosure would enable companies to provide investors with further insight into the potential reserves base that companies may use as their basis for decisions to invest in resource development. By making these disclosures voluntary, companies can decide for themselves whether to assume the increased litigation risk associated with disclosure of resources that are less certain than proved reserves estimates.

¹ Release Nos. 33-8935 and 34-58030; File No. S7-15-08, *Modernization of the Oil and Gas Reporting Requirements* (June 26, 2008) available at <http://www.sec.gov/rules/proposed/2008/33-8935.pdf> (“Proposed Rule”).

² The SEC proposal to modernize oil and gas reporting requirements was issued in response to comments received on the Concept Release published by the Commission in December 2007. The Concept Release addressed the potential implications for the quality, accuracy and reliability of oil and gas disclosures if the Commission were to revise the definition of “proved reserves” and expand the categories of resources that may be disclosed in Commission filings to include resources other than proved reserves. See Release No. 33-8870 (Dec. 12, 2007) [72 FR 71610].

³ The proposal suggests adoption of an alternate resource classification system, based primarily on Society of Petroleum Engineers Petroleum Resources Management System (“PRMS”) and Canadian National Instrument 51-101 (“NI 51-101”) standards. Although the proposed definitions are not totally consistent with either PRMS or NI 51-101, they are significantly more consistent with those standards than the existing rules. The Commission believes proposed criteria would provide greater comparability among companies’ disclosures so that investors can better understand the relative merits of their different investment choices. The proposed definition of “reserves” is based on the PRMS definition of the term. See proposed Rule 4-10(a)(28). “Proved reserves” are currently defined as reserves that are “the estimated quantities of crude oil, natural gas, and natural gas liquids which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions.” See Rule 4-10(a)(2) of Regulation S-X [17 CFR 210.4-10(a)(2)].

Determining a company's reserves.

To add clarity to the definition of the term “proved reserves,” the release proposes to define reserves as the estimated remaining quantities of oil and gas and related substances anticipated to be recoverable, as of a given date, by application of development projects to known accumulations based on:

- Analysis of geoscience and engineering data;
- The use of reliable technology;
- The legal right to produce;
- Installed means of delivering the oil, gas, or related substances to markets, or the permits, financing, and the appropriate level of certainty (reasonable certainty, as likely as not, or possible but unlikely) to do so; and
- Economic producibility at current prices and costs.

Furthermore, reserves would be classified as proved, probable, and possible according to the degree of uncertainty associated with the estimates.

- Proved- Estimates that are reasonably certain;⁴
- Probable- Estimates that are as likely as not to be achieved; and
- Possible- Estimates that might be achieved, but only under more favorable circumstances than are likely.

Currently, the technology that may be used to meet the “reasonable certainty” standard necessary to establish the proved status of its reserves is limited. The SEC proposes to add the term “reliable technology”⁵ to permit broader use of new technologies in order to establish the proper classification for reserves and to lessen the need for frequent updates to reserves definitions as technology continues to evolve. Companies would be required to disclose the technology used to establish the appropriate level of certainty for material properties in the company’s first SEC filing and for material additions.

The proposed definition of “reasonable certainty” would continue to allow companies to estimate reserves amounts using either “deterministic” or “probabilistic” methods. The proposal would define these terms in a manner consistent with industry practice.⁶ Additionally, the proposal would amend the definition of the term “proved undeveloped reserves” (“PUDs”) by replacing the requirement that productivity be “certain” with a “reasonably certain” requirement. It also would further clarify that proved reserves can be claimed in a

⁴ The proposal would define the term “reasonable certainty” as “much more likely to be achieved than not.” The proposed definition of “reasonable certainty” also would explain that, when probabilistic methods are used to estimate reserves, “reasonable certainty” means that there is at least a 90% probability that the quantities actually recovered will equal or exceed the stated volume. See proposed Rule 4-10(a)(26).

⁵ The proposal would define “reliable technology” as “technology (including computational methods) that, when applied using high quality geoscience and engineering data, is widely accepted within the oil and gas industry, has been field tested and has demonstrated consistency and repeatability in the formation being evaluated or in an analogous formation. See proposed Rule 4-10(a)(27).

⁶ The term “deterministic estimate” would be defined as an estimate that is based on using a single “most appropriate” value for each variable in the estimation of reserves, such as the company’s determination of the oil or gas in place in a reservoir, multiplied by the fraction of that oil or gas that can be recovered. In addition, the term “probabilistic estimate” would be defined as an estimate that is obtained when the full range of values that could reasonably occur from each unknown parameter (from the geoscience, engineering, and economic data) is used to generate a full range of possible outcomes and their associated probabilities of occurrence.

“conventional accumulation” or a “continuous accumulation”⁷ in a given area beyond immediately offset drilling units where economic producibility is “reasonably certain.”

Non-Traditional Sources

The proposal would revise the definition of “oil and gas producing activities” to shift the focus to the final product of such activities, regardless of the extraction technology used. The proposed definition would specifically include the “extraction of marketable hydrocarbons, in the solid, liquid, or gaseous state, from oil sands, shale, coalbeds or other nonrenewable natural resources which can be upgraded into natural or synthetic oil or gas, and activities undertaken with a view to such extraction.”⁸ Companies would be permitted to add sensitivity analysis if they believe that the disclosures resulting from the proposed revisions do not adequately reflect their business decisions.⁹

Since the proposal would expand the scope of “oil and gas producing activities” to include resources extracted by technologies other than traditional oil and gas wells, it would also expand the definition of the term “proved developed oil and gas reserves” to include such resources. The proposed new definition would state that “proved developed oil and gas reserves” would include “proved reserves” that:

- In projects that extract oil and gas through wells, can be expected to be recovered through existing wells with existing equipment and operating methods; and
- In projects that extract oil and gas in other ways, can be expected to be recovered through extraction technology installed and operational at the time of the reserves estimate.

Use of an average pricing method to determine whether resources are economically producible.

The objective of the change from year-end pricing to historical pricing is to improve comparability between companies, minimize the risk of price distortion based on a single aberrant price on an individual date, and provide a better basis for economic producibility. The proposal would value the reserves held by an oil and gas company using the unweighted arithmetic average of the closing price of the applicable hydrocarbon reserves on the last day of each month in the 12-month period prior to the company’s fiscal year end.¹⁰ The SEC believes that the current fiscal year end spot price method does not represent the general price trend and does not provide a meaningful basis for determination of reserve or enterprise value. In order to provide investors with better insight into how the management of a specific company views future pricing changes and potential future investment and operating decisions with respect to reserves, the proposal would allow companies to include a sensitivity case analysis in its filings. The analysis could show total reserves estimates based on futures prices, management’s planning prices, or other price schedules in addition to the pricing mechanism specifically required. The SEC is

⁷ The proposal would adopt definitions for the terms “continuous accumulations” and “conventional accumulations” to assist companies in determining the extent of PUDs associated with these two types of accumulations. The proposed definition of “continuous accumulations” would encompass resources that are pervasive throughout large areas, have ill-defined boundaries, and typically lack or are unaffected by hydrocarbon-water contacts near the base of the accumulation. “Conventional accumulations” would be defined as discrete oil and gas resources related to localized geological structural features or stratigraphic conditions, with the accumulation typically bounded by a hydrocarbon-water contact near its base, and which are significantly affected by the tendency of lighter hydrocarbons to “float” or accumulate above the heavier water.

⁸ See proposed Rule 4-10(a)(16).

⁹ See proposed S-K Item 1202(c).

¹⁰ This pricing standard is consistent with the PRMS’ default guidelines for the term “current economic conditions.”

not proposing to change the prices that are used for accounting purposes, except that average pricing would be used for reserve disclosures based on SFAS 69.¹¹

II. PROPOSED AMENDMENTS TO REGULATION S-K

The release also proposes a new Subpart 1200 to Regulation S-K that would update and codify the disclosure requirements related to companies engaged in oil and gas producing activities, as well as add several new disclosures the SEC believes are necessary in light of the proposed amendments to Regulation S-K.

The new disclosure items would include:

- Disclosure of reserves from non-traditional sources (i.e., bitumen, shale, coalbed methane) as oil and gas reserves;
- Optional disclosure of probable and possible reserves;
- Optional disclosure of oil and gas reserves' sensitivity to price;
- Disclosure of the development of proved undeveloped reserves, including those that are held for five years or more and an explanation of why they should continue to be considered proved;
- Disclosure of technologies used to establish additions to reserves estimates;
- Disclosure regarding material changes due to technology, prices, and concession conditions;
- Disclosure of the objectivity and qualifications of the business entity or individual preparing or auditing the reserves estimates;
- Filing a report prepared by the third party if a company represents that it is relying on a third party to prepare the reserves estimates or conduct a reserves audit; and
- Disclosure based on a new definition for the term "by geographic area."

Organization of Disclosure.

The disclosure requirements in proposed new Subpart 1200 of Regulation S-K would cause a substantial amount of an oil and gas company's disclosure to appear in tabular form, providing an outline of much of a company's operations. The proposal provides formats for tabular presentation of these disclosures. With respect to reserves, the proposed tabular format would organize reserves disclosure into the following three tables:

- An oil and gas reserves table from conventional accumulations table;
- An oil and gas reserves table from continuous accumulations table; and
- An optional sensitivity analysis table.

The disclosure would be broken down by "geographic area" and would be based on a new definition of the term, which generally would require disclosures to be specified by continent.¹² Additional tabular disclosure would include production, conversion of proved undeveloped reserves, drilling activities, wells and acreage.

¹¹ The Commission indicates it will discuss these changes with FASB. The SEC intends to monitor the IASB's preparation of IFRS guidelines to align its regulations with them.

¹² Disclosure would require greater geographic specificity if a particular country contains 15% or more of the company's global oil reserves or gas reserves, or a particular sedimentary basin or field contains 10% or more of the company's global oil reserves or gas reserves.

Although a company must present specified Subpart 1200 information in tabular form, the company may modify the format of the table for ease of presentation or to combine two or more required tables. Companies may also add information or additional tables.

Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A).

New Item 1209 would require companies to discuss material changes in proved reserves and, if disclosed, probable and possible reserves, and the sources to which such changes are attributable, including changes made due to changes in prices, technical revisions and changes in the status of any concessions held (such as terminations, renewals, or changes in provisions).

The proposed disclosure also would require companies to discuss technologies used to establish the appropriate level of certainty for any material additions to, or increases in, reserves estimates. Finally, the proposed disclosure would list matters that a company should consider in discussing known trends, demands, commitments, uncertainties and events that are reasonably likely to have a material effect on the company. The SEC believes such disclosure would be helpful because developments in the oil and gas industry and markets have made distinguishing changes resulting from these factors more important.

Disclosures Required of Independent Engineers.

To address the concerns regarding the uncertainty of estimates of unproved reserves, the SEC also proposes requiring disclosure about the person primarily responsible for preparing the company's reserves estimates and, if applicable, about the person primarily responsible for conducting a reserves audit. If the person is an employee, the company's disclosure would include measures taken to assure independence. If the person is not an employee, the company's disclosure would include a description of the person's experience and any potential conflicts of interest. If a company represents that its estimates of reserves are based on estimates prepared by a third party or a third party audit, the company would be required to file the report of the third party as an exhibit to the relevant registration statement or report. The proposal would require that report to include the following disclosure:

- The purpose for which the report is being prepared and for whom it is prepared;
- The effective date of the report and the date on which the report was completed;
- The proportion of the company's total reserves covered by the report and the geographic area in which the covered reserves are located;
- The assumptions, data, methods, and procedures used to conduct the reserves audit, including the percentage of the company's total reserves reviewed in connection with the preparation of the report, and a statement that such assumptions, data, methods, and procedures are appropriate for the purpose served by the report;
- A discussion of primary economic assumptions;
- A discussion of the possible effects of regulation on the ability of the registrant to recover the estimated reserves;
- A discussion regarding the inherent risks and uncertainties of reserves estimates;
- A statement that the third party has used all methods and procedures as it considered necessary under the circumstances to prepare the report;
- A brief summary of the third party's conclusions with respect to the reserves estimates (for audit reports); and

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- The signature of the third party.

The proposed contents of these reports mirror the guidance issued by the Society of Petroleum Evaluation Engineers regarding the preparation of such reports.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Brian Kleinhaus at 212.701.3320 or bkleinhaus@cahill.com.