

SEC Updates Oil and Gas Reporting Requirements

The Securities and Exchange Commission (“SEC” or “Commission”) recently adopted revisions to Regulations S-X and S-K in an effort to align oil and gas reporting requirements with current practices (“Adopting Release”).¹ The Adopting Release reflects a decision by the Commission to modify disclosure requirements in documents filed with the SEC for the significant technological advances, and changes in the types of projects in which oil and gas companies invest their capital, that have occurred since the existing rules were adopted three decades ago.² The effective date of these revisions is January 1, 2010. A company may not apply the new rules in quarterly reports prior to the first annual report in which the revised disclosures are required.³

The Adopting Release accomplishes three significant objectives:

- Removes the limitation in the current rules that prohibits oil and gas companies from disclosing reserves other than their proved reserves in filings with the Commission;
- Expands the types of technologies that oil and gas companies may rely upon to establish the levels of certainty required to classify reserves; and
- Allows oil and gas companies to include activities related to the extraction of oil sands, bitumen and other “non-traditional” resources to the definition of oil and gas producing activities.

The Adopting Release also significantly changes the pricing method for reserve calculation purposes, and revises and adds definitions to assist in determining the economic producibility of oil and gas reserves.⁴

¹ Release Nos. 33-8935 and 34-59192; File No. S7-15-08, *Modernization of Oil and Gas Reporting* (June 26, 2008) available at <http://www.sec.gov/rules/final/2008/33-8995.pdf> (“Adopting Release”).

² The Adopting Release adopts certain proposals set forth in the SEC proposing release to modernize oil and gas reporting requirements that was issued in June 2008 (“Proposing Release”). See Release Nos. 33-8935 and 34-58030 [73FR39526] 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>. The Proposing Release in turn 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 SEC will consider delaying the compliance date based on continuing discussions with the Financial Accounting Standards Board (“FASB”) and the International Accounting Standards Board (“IASB”) to align their accounting standards with the average pricing method to be used to determine whether resources are economically producible. See Section I(4) infra.

⁴ The Adopting Release adopts a resource classification system that is based primarily on the Society of Petroleum Evaluation Engineers Petroleum Resources Management System (“PRMS”), a broadly accepted standard for the management of petroleum resources developed by several industry organizations. Although the new definitions are not totally consistent with PRMS, they are significantly more consistent with that standard than the existing rules. The Commission believes the new criteria will provide greater comparability among companies’ disclosures so that investors can better understand the relative merits of their different investment choices. For example, the revised definition of “reserves” is substantially based on the PRMS definition of the term.

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

1. Disclosure of Probable and Possible Reserve Estimates

The SEC has changed disclosure rules to allow voluntary disclosure in filings under the Securities Exchange Act of 1934 of probable and possible reserves after the effective date of the Adopting Release. Such disclosure is currently prohibited in Exchange Act filings. The permitted disclosure will 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 potentially increased litigation risk associated with disclosure of resources that are less certain than proved reserves estimates.

2. Determining a Company's Reserves

To add clarity to the definition of the term “proved reserves,” the Adopting Release defines reserves as the “estimated remaining quantities of oil and gas and related substances anticipated to be economically producible, as of a given date, by application of development projects to known accumulations. In addition, there must exist, or there must be a reasonable expectation that there will exist, the legal right to produce or a revenue interest in the production, installed means of delivering oil and gas or related substances to market, and all permits and financing required to implement the project.”⁵

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,⁶
- 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 a company may use to meet the “reasonable certainty” standard necessary to establish the proved status of its reserves is limited. The SEC is adopting the term “reliable technology”⁷ which will permit broader use of new technologies in order to establish the proper classification for reserves and to

⁵ See Rule 4-10(a)(26).

⁶ The Adopting Release defines “reasonable certainty” as “a high degree of confidence that the quantities will be recovered.” A high degree of confidence “exists if the quantity is much more likely to be achieved than not, and as changes due to increased availability of geoscience (geological, geophysical and geochemical), engineering and economic data are made to estimated ultimate recovery (EUR) with time, reasonably certain EUR is much more likely to increase or remain constant than to decrease.” The definition also explains that when probabilistic methods are used to estimate reserves, “reasonable certainty” means that “there should be at least a 90% probability that the quantities actually recovered will equal or exceed the estimate.” See Rule 4-10(a)(24).

⁷ The Adopting Release defines “reliable technology” as “a grouping of one or more technologies (including computational methods) that has been field tested and has been demonstrated to provide reasonably certain results with consistency and repeatability in the formation being evaluated or in an analogous formation.” See Rule 4-10(a)(25). In response to some commenters’ concerns that disclosure of technologies might lead to potentially cumbersome and confusing disclosure and competitive harm, companies will be permitted to disclose a concise summary of their relevant technologies used to create their reserves estimates.

lessen the need for frequent updates to reserves definitions as technology continues to evolve. Companies will be required to disclose the technology used to establish the appropriate level of certainty for material properties in their first SEC filing and for future filings that disclose material additions to their reserves estimates.

The definition of “reasonable certainty” will continue to allow companies to estimate reserves amounts using either “deterministic” or “probabilistic” methods. The Adopting Release defines these terms in a manner consistent with industry practice.⁸ Additionally, the Adopting Release amends the definition of the term “undeveloped oil and gas reserves” by replacing the requirement that productivity be “certain” with a “reasonably certain” requirement for undrilled areas beyond one offsetting drilling unit from a producing well.⁹

3. Non-Traditional Sources

As the energy resources that are supplied to the global economy are increasingly being augmented from sources that involve extraction by means other than “traditional” oil and gas wells, the Adopting Release has revised 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 definition specifically includes the “extraction of saleable hydrocarbons, in the solid, liquid, or gaseous state, from oil sands, shale, coalbeds or other nonrenewable natural resources which are intended to be upgraded into natural or synthetic oil or gas, and activities undertaken with a view to such extraction.”¹⁰ As an example of the focus shift, companies that are involved in extraction of coal and oil shale should take note that only the amounts of such resources that are intended to be extracted and used as feedstock to be converted into oil and gas and sold into the market, and not intended to be used as direct fuel or some other application, should be included in those companies’ oil and gas reserve estimates calculations. Companies will be permitted, but not required to, add a sensitivity analysis if they believe that the disclosures resulting from the revised rules do not adequately reflect their business decisions.¹¹

Since the Adopting Release expands the scope of “oil and gas producing activities” to include resources extracted by technologies other than traditional oil and gas wells, it also revises the definitions of the term “developed oil and gas reserves” and “undeveloped oil and gas reserves” to include all such resources. The definition of “developed oil and gas reserves” includes all reserves of any category that can be expected to be recovered:

- Through existing wells with existing equipment and operating methods or in which the cost of the required equipment is relatively minor compared to the cost of a new well; and
- Through installed extraction equipment and infrastructure operational at the time of the reserves estimate if the extraction is by means not involving a well.¹²

⁸ A method of estimating of reserves or resources “is called deterministic when a single value for each parameter (from the geoscience, engineering, or economic data) in the reserves calculation is used in the reserves estimation procedure.” See Rule 4-10(a)(5). The term “probabilistic estimate” is defined as an estimate that is obtained “when the full range of values that could reasonably occur from each unknown parameter (from the geoscience and engineering data) is used to generate a full range of possible outcomes and their associated probabilities of occurrence.” See Rule 4-10(a)(19).

⁹ See Rule 4-10(a) 31.

¹⁰ See Rule 4-10(a)(16).

¹¹ See Regulation S-K Item 1202(b).

¹² See Rule 4-10(a)(6).

The definition of “undeveloped oil and gas reserves” includes all reserves of any category “that are expected to be recovered from new wells on undrilled acreage, or from existing wells where a relatively major expenditure is required for recompletion.”¹³

4. Use of an Average Pricing Method to Determine Whether Resources are Economically Producing.

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 SEC has chosen to require oil and gas companies to value their reserves by using the unweighted arithmetic average of the closing price of the applicable hydrocarbon reserves on the first day of each month in the 12-month period prior to the company’s fiscal year end.¹⁴ The SEC believes that the current fiscal year end spot price method may not adequately represent the general price trend and does not provide as meaningful a 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 Adopting Release permits, but does not require, companies to include a sensitivity case analysis in a tabular format in its filings.¹⁵

Concurrent with the change to reserve estimate pricing for disclosure purposes, the Adopting Release is applying the 12-month average price for calculating reserve estimates for accounting purposes as well. Although the Proposed Release contemplated not changing the single-day, year end price assumption for use in the accounting context, the SEC received unanimously negative reactions from commenters who responded to this part of the proposed revision. The SEC was persuaded by those responses and chose to adopt a consistent pricing scheme for both disclosure and accounting frameworks.¹⁶

II. ADOPTED AMENDMENTS TO REGULATION S-K

The Adopting Release also adds a new Subpart 1200 to Regulation S-K that updates and codifies the disclosure requirements related to companies engaged in oil and gas producing activities, as well as adding several new disclosures the SEC believes are necessary in light of the amendments to Regulation S-X.

The new disclosure items 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;

¹³ See Rule 4-10(a)(31).

¹⁴ This pricing standard is consistent with the PRMS’ default guidelines for the term “current economic conditions.” The Proposing Release had suggested using the closing prices on the last day of each month in the applicable 12-month period. In response to several comments, the Adopting Release has switched the pricing day to the first day of each month, so as to effectively give companies an additional month to prepare their reserve disclosures.

¹⁵ See Regulation S-K Item 1202(b). If a company chooses to provide such a table, it will also then have to disclose the price and cost schedules and assumptions used as the basis for such alternate reserve estimates.

¹⁶ If the final rule retained two separate pricing schemes, companies would effectively be required to calculate reserves twice, once for disclosure purposes and once for accounting purposes. The SEC will continue to communicate with the FASB and IASB to align their respective published accounting standards with these changes.

- Optional disclosure of oil and gas reserves' sensitivity to price;
- Disclosure of the company's progress in converting proved undeveloped reserves into proved developed 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 in a company's initial filing with the Commission and future filings which include material additions to reserve estimates;
- The company's internal controls over reserves estimates and the qualifications of the technical person primarily responsible for overseeing the preparation or audit of the reserves estimates;
- Disclosure of a company's internal controls over reserves estimation and the objectivity and qualifications of the business entity or technical individual primarily responsible for overseeing the process related to the preparation or auditing of the reserves estimates;
- Disclosure based on a new definition for the term "by geographic area."; and
- If a company represents that disclosure is based on the authority of a third party that prepared the reserves estimates or conducted a reserves audit or process review, filing a report prepared by the third party.

1. Organization of Disclosure

The disclosure requirements in the new Subpart 1200 of Regulation S-K will 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.¹⁷ The Adopting Release provides formats for tabular presentation of these disclosures. With respect to reserves, the tabular format organizes reserves disclosure into the following tables:

- A table for proved, and if desired, probable and possible, oil and gas reserves that requires disclosure by final product; and
- An optional sensitivity analysis table.¹⁸

The reserves estimate for the reserves table is to be based on the same 12-month average pricing method developed for disclosure under Regulation S-X. The disclosure is to be broken down by "geographic area" and is based on a new definition of the term, which generally would require disclosures to be specified by continent, groups of countries within a continent, or by individual country.¹⁹ Additional disclosure includes production, conversion of proved undeveloped reserves, drilling activities, wells and acreage.

¹⁷ Subpart 1200 takes the place of and codifies the current Industry Guide 2.

¹⁸ See Item 1202(b).

¹⁹ See Item 1201(d). With respect to production data, proper disclosure requires greater geographic specificity if a particular country or a particular field contains 15% or more of the company's total global oil and gas reserves, on a barrels of oil equivalent basis, unless such disclosure is prohibited by the country in which the resources are located. See Item 1204(a). Companies are required to disclose reserves estimates for each country containing 15% or more of a company's proved reserves, on a barrels of oil equivalent basis, except that a company need not (a) provide disclosure of its reserves estimates in a country containing at least 15% of its proved reserves if that country's rules and regulations prohibit such disclosure and (b) provide disclosure of its reserves estimates in a country containing 15% or more of the company's proved reserves if that country's rules and regulations prohibit disclosure in a particular field and disclosure of reserves in that country would have the effect of disclosing reserves in a particular field or fields. See Item 1202(a)(2), Instruction 4.

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

The Proposed Release had contemplated a new Item 1209 of Regulation S-K that would require companies to discuss a list of specified topics in its Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A").²⁰ Based on commenters' reactions, the SEC has chosen not to adopt proposed Item 1209, but instead is advising companies that to the extent "any discussion of known trends, demands, commitments, uncertainties and events that are reasonably likely to have a material effect on a company is directly relevant to a particular disclosure required by new Subpart 1200, the company may include that discussion or analysis with the relevant table, with appropriate cross references, rather than including it in its general MD&A section."²¹

2. Disclosures Required of Internal Controls and Qualifications of Internal or Independent Reserves Evaluators

To address the concerns regarding the uncertainty of estimates of unproved reserves, the SEC will require disclosure about the person or entity primarily responsible for overseeing the technical process of preparing the company's reserves estimates and, if applicable, about the person or entity primarily responsible for conducting a reserves audit. Although the Proposed Release initially proposed that such a technical person possess certain qualifications and be subject to a list of controls for maintaining objectivity²², the responses of several commenters led the SEC to instead require a company to provide a general discussion of the internal controls that it uses to assure objectivity in the reserves estimation process and the disclosure relating to the qualifications of the person or entity primarily responsible for preparing the reserves estimate or conducting the reserves audit.²³

If a company represents that its estimates of reserves are based on estimates prepared by a third party or a third party reserves audit²⁴, the company will be required to file the report of the third party as an exhibit to the relevant registration statement or report. The Adopting Release requires that report include the following disclosure:

²⁰ See Proposing Release Section III(B)(10) and proposed Item 1209.

²¹ See Adopting Release Section II(V). Recommended topics for discussion related to the tabular disclosure should include, if material to a particular company's operations, technologies used to establish the appropriate level of certainty for any material additions to, or increases in, reserves estimates, changes in prices and costs, performance of currently producing wells, success in converting proved undeveloped reserves into proved developed reserves, geopolitical risks, and other applicable factors.

²² See Proposing Release Section III(B)(3)(v) and proposed Instruction 3 to Item 1202(a)(2).

²³ The SEC was persuaded by several commenters that requiring a prescribed list of qualifications and objectivity requirements might prove to be too rigid and possibly redundant, as licensing requirements can vary greatly among jurisdictions and because the internal controls of a company's management should be sufficient to ensure the objectivity of any technical person and the reliability of reserves estimates. See Adopting Release Section (IV)(B)(3)(d).

²⁴ A "reserves audit" means "the process of reviewing certain of the pertinent facts interpreted and assumptions underlying a reserves estimate prepared by another party and the rendering of an opinion about the appropriateness of the methodologies employed, the adequacy and quality of the data relied upon, the depth and thoroughness of the reserves estimation process, the classification of reserves appropriate to the relevant definitions used, and the reasonableness of the estimated reserves quantities." See Item 1202(a)(9).

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- 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 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;
- The signature of the third party;
- If the report is related to a reserves audit, a brief summary of the third party's conclusions with respect to the reserves estimates; and
- If the disclosure is being made in, or incorporated by reference to, a Securities Act registration statement, a consent by such third party.²⁵

The contents of these reports mirror the guidance issued by the Society of Petroleum Evaluation Engineers regarding the preparation of such reports.²⁶

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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.

²⁵ See Item 1202(a)(8).

²⁶ Similarly, if a company discloses that it has hired a third party to conduct a process review, it “must clearly disclose the details surrounding that process review file a report of that third party as an exhibit to the relevant registration statement or report and if the disclosures are made in, or incorporated into, a Securities Act registration statement, the company must file a consent of the third party as an exhibit to the filing.” See Adopting Release Section IV(B)(3)(f). According to the Society of Petroleum Evaluation Engineers standards, a process review should be limited to an evaluation of the adequacy and effectiveness of a company's internal processes and controls relative to a reserves estimate, but should not include an opinion as to the reasonableness of a company's reserves quantities. A process review is not equivalent to a reserves audit and companies should take the necessary steps to make the distinction clear in their disclosure.