

THE NEW SEC RESERVE RULES

If SEC proposals are adopted as expected, E&P companies will be able to report their reserves differently in 2009.

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Excerpted from

**Oil and Gas
Investor**

August 2008
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Publishing
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After decades of lobbying the SEC to revise its antiquated reserves-reporting structure, the oil and gas industry was finally granted the floor to voice its recommendations late last year when the SEC issued its long-awaited “concept release” of proposed changes.

During the two-month public commenting period, the SEC received approximately 80 letters from industry participants including E&P companies, accounting and law firms, financial institutions and government energy committees about the proposed measures, which are designed to upgrade the existing reporting system.

This dialogue is finally bearing fruit. In late June, the SEC’s division of corporate finance and the office of the chief accountant announced its proposed revisions to the reporting structure, for the full SEC to review, based on the public’s recommendations.

Final versions of the oil and gas reserves-reporting requirements will be announced in early fall after a second round of comments, which is not expected to generate much in the way of objections to the proposed rules. The SEC proposes compliance with the new disclosure requirements, if adopted, for registration statements filed on or after January 1, 2010, and for annual reports for fiscal years ending on and after December 31, 2009, with no option to adopt earlier.

The proposed revisions show a willingness to do more than just tweak oil and gas reserve-reporting requirements.

A shared belief voiced in the majority of the responses to the concept release—and implicit in the proposed rule changes—is that reforming the current regulations will better reflect advances in the energy industry, and investors will be provided with a more informed, complete and reliable snapshot of a company’s oil



and gas reserves.

The SEC proposes allowing companies to disclose more about their unconventional resources, and their probable and possible reserves, not just proved reserves.

Many respondents championed core reforms to the existing regulatory framework: permission to include unconventional resources as proven reserves in filings; recognition of new technologies, such as seismic imaging and horizontal

drilling, to quantify reserves; a shift from using a fiscal-year-end price schedule to using an average annual price standard to reduce volatility; and adopting the definitions framework of the Society of Petroleum Engineers’ Petroleum Resources Management System (PRMS).

On the flip side, respondents were divided over the SEC’s proposal to allow E&P companies to disclose reserves other than proved reserves. Many companies report their reserves potential in investor communications in multiple ways: using approved SEC standards for proved reserves only; SPE definitions for proved, probable and possible reserves; and/or larger but less definitive numbers for the company’s estimated undeveloped resource base.

The majority of industry respondents also overwhelmingly rejected the SEC’s proposal to require a third party to evaluate disclosed oil and gas reserves.

Unconventional reserves

Across the commenting period, the SEC’s proposal to permit previously excluded nontraditional sources of oil and gas in reserve reporting was positively received.

As pressure has been applied by policymakers to discover alternative sources of energy, the energy industry has responded by seeking valuable hydrocarbons in unconventional prospects such as ultra-deepwater production,

SEC Proposed Rules at a Glance

The SEC's "Concept Release"	Industry Responses	Proposed Rules
1. Replace SEC rules-based current oil and gas reserves disclosure requirements with a principles-based rule?	Some responders reject this shift wholesale while many agree that more selective updates to the definitions would be beneficial.	No comment yet.
2. Consider allowing companies to disclose reserves other than proved reserves in filings with the SEC?	Most industry insiders agree that reporting unproved reserves would be misleading to investors as these reserves are not as valuable. However, other responders, such as the U.S. Energy Information Administration, recommended that companies should have the option to report their probable and possible reserves for investor transparency.	Proposal to make these disclosures voluntary. Will require disclosure about the person primarily responsible for preparing the company's reserves estimates.
3. Adopt all or part of the SPE's Petroleum Resources Management System?	The majority of responders feel that using this would provide immeasurable oversight for the SEC when revising its framework.	Proposed new and revised definitions classifications based on both SPE's PRMS and the Canadian National Instrument 51-101.
4. Consider revising the current definition of proved reserves, proved developed reserves and proved undeveloped reserves?	Many responders feel the current definitions of such terms were acceptable but note that they should be checked against the SPE's PRMS definitions.	Will add a definition of the term "reserves" to describe more completely the criteria that an accumulation of oil, gas or related substances must satisfy to be considered reserves. Will expand the definition of the term "proved developed reserves" to include extraction of resources using technologies other than production through wells.
5. Specify the tests a company must undertake to estimate reserves?	The unanimous response is that these tests must be in keeping with those of the PRMS, which reflects advances in technology.	Companies would now be able to select the technology used and will be required to disclose the technology for investors to determine whether that technology was appropriate.
6. Reconsider the concept of reasonable certainty?	Most industry members feel the concept is acceptable but it should be more clearly defined.	Propose to define the term as "much more likely to be achieved than not" under a deterministic or probabilistic method. When probabilistic methods are used, reasonable certainty means that there is at least a 90% probability that the quantities actually recovered will equal or exceed the stated volume.
7. Reconsider the concept of certainty with regard to proved undeveloped reserves?	The majority response is that this concept must be aligned with the SPE's PRMS definition.	Propose to define proved undeveloped reserves as reserves 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. Undrilled locations can be classified as PUDs generally if there is a development plan adopted to drill within five years.
8. Reconsider the concept of economic produceability?	Most respondents object to redefining this concept as it has been embraced and used by the industry.	Propose term to mean, "a resource which generates revenue that exceeds, or is reasonably expected to exceed, the costs of the operation."
9. Reconsider the concept of existing operation conditions?	The collective responding whole objected to redefining this concept as it has been embraced and used by the industry.	No change.
10. Should we require or allow companies to use an average price instead of a fixed price, or a futures price instead of a spot price?	Industry members wholly advocate using an average price to reduce price volatility.	Propose to change the price used in calculating reserves from a single-day closing price measured on the last day of the company's fiscal year to an average price for the 12 months prior to the end of the company's fiscal year. Will add a disclosure item to permit a company, at its option, to include a sensitivity-case analysis.
11. Consider eliminating any of the current exclusions from proved reserves?	Given the abundance of nontraditional oil and gas resources today, the industry collectively approves elimination of the current exclusions from proved reserves.	The proposed definition would state that oil and gas producing activities 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.
12. Consider eliminating any of the current exclusions from oil and gas activities?	Given the abundance of nontraditional oil and gas resources today, the industry collectively approves elimination of the current exclusions from proved reserves.	Consistent with the answer above. Would continue to exclude activities relating to transporting, refining and processing; the production of resources other than oil or gas or resources from which natural or synthetic oil and gas can be extracted; and the production of geothermal steam.
13. Consider eliminating the current restrictions on including oil and gas reserves from sources that require further processing?	The majority response is that this concept must be aligned with the SPE's PRMS definition.	Consistent with the answer above. Would continue to exclude activities relating to transporting, refining and processing; the production of resources other than oil or gas or resources from which natural or synthetic oil and gas can be extracted; and the production of geothermal steam.
14. What aspects of technology should be considered in evaluating a disclosure framework?	The majority response is that this concept must be aligned with the SPE's PRMS definition.	Must be consistent with the definition of "reliable technology," that is, expressed in realistic terms, has been proved empirically to lead to correct conclusions in more than 90% of its applications.
15. Consider requiring companies to engage an independent third party to evaluate their reserves estimates in the filings?	Many industry responses are against this measure, while a few responses from the accounting and legal industries feel that engaging a third party would ensure reliability of proving accurate reserve estimates.	Will not propose to require an independent third party. Will require disclosure regarding the qualifications of the person responsible for preparing reserves estimates.

The SEC has shown that it is well aware of technology shifts and changing project profiles in the E&P business.

extra-heavy oils, gas-to-liquids (GTL), coal-to-liquids (CTL) and biofuels.

The U.S. Energy Information Administration (EIA) estimates that the supply from unconventional gas formations (tight gas, coalbeds and gas shales) now represents 45% of U.S. gas production, which clearly explains the industry's strong desire to include these resources.

Oil and gas companies have been locating nontraditional resources through innovative technological advances, such as horizontal drilling, advanced formation-fracturing techniques, seismic imaging and reservoir-simulation models. All of these have transformed the industry into a diverse technological powerhouse. U.S. gas production has been rising, especially thanks to the many shale-gas plays now being aggressively developed.

Currently, SEC disclosure requirements dictate a conclusive actual product or flow test of a well, except in the Gulf of Mexico, to measure reserves. Clearly, this limited scope of testing for reserve quantities does not even begin to scratch the surface of the contemporary techniques being used by the industry. The proposed rules move this issue forward significantly.

Horse whispering

In an era in which the only thing that can be accurately predicted is extreme volatility in oil and gas prices, it seems logical that the industry would unanimously wish to overhaul the requirement to report based only upon a year-end oil and gas price in determining proved reserve quantities.

When the SEC reporting system was introduced in the 1980s, U.S. oil and gas prices were controlled and present-day conflicting global energy markets were not yet developed. Industry insiders point out that, even in relatively stable periods, it is rare for year-end commodity prices to even compare with the annual average price for oil and gas, given the erratic daily fluctuations that are part and parcel of the energy industry today.

Using some period of average prices in benchmarking reserves quantities would not only be a much more accurate portrayal for investors, it would help eliminate price volatility in general.

Many industry insiders agree that incorporating the newly revised PRMS within the SEC's own guidelines would provide an indispensable blueprint for navigating through the unique challenges and changes facing the industry today. The PRMS is designed to reflect newer techniques and energy-company practices, and is used by E&P companies to prepare reserves estimates for many purposes other than SEC filings.

In its comments to the SEC, the American Petroleum Institute (API) notes that the SEC "should adopt the (Society of Petroleum Engi-

neers') PRMS as the sole technical framework, which registrants should follow in analyzing and categorizing their oil and gas reserves."

Snuffing out risk

In keeping with the quest for investor transparency, many energy insiders have strongly opposed the SEC's proposal to allow E&P companies to disclose reserves other than proved reserves in filings. Although the current guidelines require that reserves must be proved—according to the SEC's slightly murky concept of "reasonable certainty"—industry insiders have become highly familiar with this concept when classifying and disclosing proved reserves. They indicated in their responses that only minor adjustments need to be made to this concept.

By requiring companies to disclose reserves other than proved reserves, responders argue that the concept of "reasonable certainty" would undoubtedly be dismantled.

The API cautions in its comments, that "we believe that investors...would not be well served by the mandated inclusion of probable reserves...below the proved threshold, due to the increased uncertainty of resources in these categories...."

In the wake of reserve-reporting scandals in recent years, the SEC proposes the concept of mandatory engagement of an independent third party to evaluate reserves disclosed in filings. It said that E&P companies must recognize that identifying the scope of the third party's role, identifying proper qualifications and professional standards, and enforcing such standards might require relying on a professional organization outside the SEC's control.

As can be expected, the oil industry presented a united defensive front against this notion. The API forcefully argued that in-house technical staffs were the most efficient and knowledgeable purveyors of a company's reserves data, and that contracting an independent third party in a deadline situation would not ultimately result in the most accurate reserve reporting. The SEC has agreed.

The SEC has shown that it is well aware of technology shifts and changing project profiles in the E&P business. Given the pervasive topic of global warming in any energy discussion, there is no doubt that new technologies will emerge and evolve to meet the world's vast energy demands. This, of course, will undoubtedly require more fine tuning of the reserve-reporting framework in the years to come. But for now, the industry has spoken and the SEC has tuned in. □

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For more on the SEC's plans to revise reserves-disclosure rules, see this article online at OilandGasInvestor.com.

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