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SEC Amends Reporting Requirements for Oil & Gas Companies

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On December 29, 2008, the Securities and Exchange Commission ("SEC") adopted rule amendments designed to update and modernize the reporting requirements applicable to oil and gas companies. The amendments mark the first significant change to the disclosure rules adopted for oil and gas companies more than 25 years ago.

Background

The reporting requirements of oil and gas exploration and production companies are largely the same today as those first adopted by the SEC in 1978 and 1982. As time passed and the oil and gas industry underwent considerable change, the disclosure rules were increasingly criticized as not being aligned with current industry practices (and, therefore, of limited value to investors). In response to this criticism, the SEC in December 2007 issued a concept release on possible rule revisions.[1] With substantial input from industry participants, law firms, regulatory agencies, and other interested parties, the SEC proposed broad-sweeping amendments to the reporting requirements in June 2008.[2] The SEC unanimously adopted the revisions on December 29, 2008, and final rules were issued on December 31, 2008.[3]

Current Disclosure Rules

Under the current rules, proved reserves are oil and gas reserves that are reasonably certain of being produced under existing economic and operating conditions. Oil and gas producing activities are limited to the extraction of hydrocarbon resources from traditional resources (i.e., oil and gas wells). Processes used to extract resources from non-traditional sources (i.e., anything other than oil and gas wells such as tar sands and oil shales) are deemed not to be oil and gas producing activities. Consequently, resources extracted from traditional sources may qualify as proved reserves, whereas resources extracted from non-traditional sources cannot qualify as proved reserves for reporting purposes.

Although oil and gas companies consider non-proved reserves (including probable and possible reserves) when making investment decisions such as whether to develop a new field or drill a new well, companies are generally permitted to disclose only proved reserves in their SEC filings. For reporting purposes, proved reserves are calculated using the closing spot market prices on the last day of a company's fiscal year – commonly, the December 31st spot market price at the Henry Hub (gas) and the West Texas Intermediate price at Cushing, Oklahoma (crude).

New Reporting Requirements

Highlights of the new reporting requirements include:

- **Classifying Non-Traditional Resources as Reserves.** The new rules eliminate the distinction between resources extracted from traditional sources and those extracted from non-traditional sources. Under the new rules, oil and gas producing activities will include the extraction of saleable hydrocarbon resources from the non-traditional source, regardless of the technology employed to extract the saleable resources from non-traditional sources. Accordingly, gas from unconventional shale formations, bitumen from oil sands, and coalbed methane may qualify as reserves for reporting purposes.[4]

- **Using New Technologies to Determine Reserves.** Oil and gas companies are today required to use actual production or flow tests (except in the Gulf of Mexico) to satisfy the "reasonable certainty" standard required for proved reserves. Under the new rules, companies will be permitted to use a wider variety of new technologies (e.g., 3-D and 4-D seismic technology) to establish reserve estimates and categories, to the extent the technology has been field tested and has demonstrated a high degree of consistency and reliability.[5]

- **Disclosing Probable and Possible Reserves.** Oil and gas companies will be permitted, but not required, to disclose probable reserves (i.e., reserves less likely to be recovered than proved reserves, but as likely as not to be recovered) and possible reserves (i.e., reserves less certain to be recovered than probable reserves). If a company elects to disclose probable and possible reserves, the company will be required to disclose the same level of detail as required for proved reserves under the new disclosure rules.

- **Calculating Reserves Using 12-Month Average Prices.** Oil and gas companies will be required to calculate reserves based on annual average commodity prices, which will be determined using the unweighted average of the closing spot market price on the first day of each month in the 12-month reporting period.[6] Given that reserve estimates based on 12-month average prices may vary significantly from estimates based on other price and cost criteria, a reporting company will also be permitted to voluntarily disclose a reserves sensitivity analysis table showing total reserves based on the company's planning prices, forecast oil and gas prices, or other price schedules.

- **Filing of Third-Party Reports.** Today, if an oil and gas company represents that it has relied on a third party for a portion of its filing, the reporting company must obtain the third party's consent to disclose such information. Under the new rules, if an oil and gas company represents that its reserve estimates were prepared or based upon estimates provided by a third party, or that a third party conducted a process review or reserves audit, the reporting company will be required to file with the SEC the third-party report (reserves estimate or process review) or a summarized version of the third-party report (reserves audit), as applicable.

In addition to the fundamental changes described above, oil and gas companies will be required to provide several new disclosures about reserves. Among other things, a reporting company will be required to (i) discuss exploration and production activities involving the extraction of resources by mining techniques, which are commonly used to extract bitumen, coal, and shale; (ii) provide a new table distinguishing final products that are traditional oil and gas from final products of synthetic oil or gas; (iii) discuss its internal controls over the company's reserve estimate efforts and the qualifications of the technical person primarily responsible for overseeing the preparation of the company's reserves estimates and, if a third party conducted a reserves audit, the technical person primarily responsible for overseeing the reserves audit; and, (iv) disclose total proved undeveloped reserves at year end, and discuss the reasons why any such reserves have not been developed for five or more years and the company's plans to develop those reserves.

The new reporting requirements become effective on January 1, 2010, and voluntary early compliance with the new reporting requirements is not permitted.[7]

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Due to the magnitude of the rule changes and the technical nature of the subject matters involved, oil and gas companies will almost certainly spend considerable time and resources preparing for the new disclosure requirements. The administrative aspects aside, companies are encouraged to consider, for example, (i) the appropriateness of referencing the reporting changes in safe-harbor factors prepared for forward-looking statements; (ii) whether and how the new rules may impact existing or anticipated finance arrangements; (iii) the company's ability to obtain reserve-related reports from outside consultants, given the new filing requirements and the perceived liability risks of filing reports under securities law; (iv) how the changes could impact a company's valuation and stock price, including whether voluntary disclosure of probable and possible reserves may bolster a company's investor "story"; and, (v) whether voluntary disclosure of probable and possible reserves subjects a company to increased take-over risk, given that many oil and gas companies have looked at M&A transactions as a way to replenish depleted reserves more quickly than developing new reserves organically.

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[1] Release No. 33-8870 (December 12, 2007).
[2] Release No. 33-8935 (June 27, 2008).
[3] Release No. 33-8995 (December 31, 2008), available online at *http://www.sec.gov/rules/final/2008/33-8995.pdf*.
[4] Under the final rules (as compared to the proposed amendments), oil and gas reserves will include coal and oil shale intended to be converted into oil and gas. Coal and oil shale that is not intended to be converted into oil and gas may not be reported as reserves. See Rule 4-10(a)(16) [17 CFR 210.4-10(a)(16)].
[5] Under the proposed amendments, the definition of "reliable technology" required such technology to be widely accepted with the oil and gas industry and (expressed in probabilistic terms) to lead to correct conclusions in 90% or more of its applications. The SEC did not adopt these aspects of the proposed definition. See Rule 4-10(a)(25) [17 CFR 210.4-10(a)(25)].
[6] Under the final rules (as compared to the proposed amendments), companies may use contractual prices to establish economic producibility in circumstances where the applicable oil and gas prices are determined pursuant to a contractual arrangement. See Rule 4-10(a)(22) [17 CFR 210.4-10(a)(22)]. Although the proposed amendments would have resulted in companies using a 12-month average price standard for reporting purposes and a single-day, year-end price for full-cost accounting rules, the final rules clarify that the same 12-month average price standard should be used for both reporting and accounting standards.
[7] The final release indicates the SEC will, in discussing the new reporting requirements with the FASB and IASB, consider whether to delay the January 1, 2010 compliance date.

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