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Modernization of SEC Oil and Gas Reporting Requirements

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Client Advisory
July 3, 2008 by Guy P. Lander

On June 26, 2008, the SEC issued a Release (Release No. 33-8935, also designated Release No. 34-58030) in which it proposes to amend, for the first time in 26 years, the disclosure requirements applicable to issuers in the oil and gas industry. In the Release, the SEC recognizes that, over the years, there have been significant changes in the industry, including technological advances and changes in the types of projects undertaken. As a result, the existing rules are disconnected from industry practices and, therefore, of limited use to the market and investors.

The proposed new rules would apply to "foreign private issuers"[1] as well as to "domestic issuers."

The Release which provides for a 60-day comment period during which interested persons may submit their views on the proposed amendments, is lengthy (172 pages) and detailed. The Release may be found at http://www.sec.gov/rules/proposed/2008/33-8935.pdf and we urge you to refer to it for additional information if this topic is of particular interest or concern to you.

Important Notes for Canadian Companies

The definitions and classifications used in Canadian National Instrument 51-101 form the basis, in large measure, for the proposed SEC rules. However, one important difference is that the SEC rules would continue to require the use of historical rather than forecasted prices and costs in pricing reserves.

More importantly, most Canadian companies that file registration statements or reports with the SEC do so under the Canada/United States Multijurisdictional Disclosure System (MJDS). MJDS permits such companies to satisfy their U.S. disclosure requirements by using their Canadian disclosure documents, which are prepared in accordance with Canadian law and practice. Hence, many of the proposed amendments of the rules relating to oil and gas reporting requirements will not affect the current disclosure practices of most of our Canadian clients in the industry.

Selected Highlights of the Proposed Changes

Timing of Pricing. The proposed amendments would, for reserve reporting purposes, change the price used in calculating the estimated value of reserves from the price in effect on the last day of the fiscal year to the unweighted arithmetical average of the closing prices in effect on the last day of each month in the 12-month period. The Release specifies that the reporting company would, at its option, be permitted to include a reserves sensitivity analysis table that would show what the reserve estimates would be if they were "based on different price and cost criteria, such as a range of prices and costs that may reasonably be achieved, including standardized futures prices or management's own forecasts."

Prices Used for Accounting Purposes. Notwithstanding the proposed change mentioned above to average prices in effect during the period for reserve reporting purposes, the single-day, year-end price would continue to be used for accounting purposes (i.e., to determine depreciation and, in the case of companies using the full cost accounting method, for determining the limitation on capital costs (the ceiling test)).

Bitumen and Other Non-Traditional Resources. The definition in the SEC rules of "oil and gas producing activities" would be amended to include the extraction of marketable hydrocarbons from oil sands, shale, coalbeds or other non-renewable natural resources that can be upgraded into natural or synthetic oil and gas, provided that companies engaged in such activities provide a discussion of the techniques they are using for such extraction.

Definition of "Proved Reserves". The definition of "proved reserves" would be made more specific by spelling out that in the requirement that geographical and engineering data demonstrate that reserves so classified must be recoverable with "reasonable certainty" the term "reasonable certainty" means "much more likely to be achieved than not." Several other technical requirements in connection with the classification of reserves as "proved" would also be defined.

Unproved Reserves ("Probable Reserves" and "Possible Reserves"). The proposed amendments would permit the disclosure of unproved reserves (although such disclosure would be voluntary because it might involve increased risk of litigation). The Release identifies "proved reserves" as reserve estimates that are reasonably certain, "probable reserves" as those that are as likely as not to be achieved and "possible reserves" as those that might be achieved, but only under more favorable conditions than are likely. The proposed rules provide specific guidance in categorizing reserve estimates as "proved," "probable" and "possible." Additionally, the Release notes concerns about proved undeveloped reserves that are carried as such for extended time periods (thereby putting into question whether the company has a bona fide intention or the capability to develop these reserves). To address these concerns, the SEC has proposed a rule that would require disclosure of additional information about the company's proved undeveloped reserves, including a statement of its plans to develop them and an explanation of the reasons for the lack of development of proved undeveloped reserves that have been so categorized for five years or more.

Disclosure Tables. The proposed rules would require that the disclosure document contain a table disclosing, both in the aggregate and by geographic area, estimated proved developed, proved undeveloped and total reserves (using prices and costs under existing economic conditions). The table may, at the option of the issuer, state probable and possible reserves, but only if there is disclosure of the relative risks related to the reserve estimates.

Preparation of Reserve Estimates; Reserve Reports. The SEC acknowledged the practice of some companies (especially larger ones) to prepare reserves estimates internally and rejected the notion of requiring that all reserves estimates be prepared or audited by independent third parties. However, the proposed amendments would require companies to disclose the qualifications of the person primarily responsible for preparing reserves estimates and, if an audit is conducted, of the person conducting it. Additionally, where a company relies on a third party for reserves estimates, it would be required to file with the SEC the consent of such third party to being named in the disclosure document. Moreover, the company would be required to file with the SEC a report of the third party summarizing the scope of the work performed and the conclusions of such third party. The requirement would be for a summary report, rather than a full reserves report which is more detailed and can be voluminous.

Additional Disclosures. The Release proposes the adoption of a new rule that would require a narrative description (either in the MD&A or in a separate section) of certain items (changes in prices, technical changes and changes in the status of concessions) that would supplement the reconciliation required by SFAS 69. The proposed rule would also set forth a laundry list of matters that a company should consider in satisfying its MD&A requirement to discuss known trends, demands, commitments, uncertainties, and events that are likely to have a material effect on the company.

Effective Dates. If adopted, the proposed amendments would be effective for registration statements filed under the Securities Act on or after January 1, 2010 and for annual reports on Forms 10-K and 20-F filed under the Securities Exchange Act for fiscal years ended on or after December 31, 2009.

Questions regarding this client advisory may be directed to **Guy P. Lander** at (212-238-8619, lander@clm.com).

Endnotes

[1] "Foreign private issuers" are most public companies formed under non-U.S. laws that file their annual reports with the SEC on Form 20-F or Form 40-F.

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