

## SEC Amends Oil and Gas Reporting Requirements

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### Client Advisory

February 2, 2009 by Guy P. Lander

On June 26, 2008, the SEC issued a Release (the "Proposing Release") in which it proposed to amend, for the first time in 26 years, the disclosure requirements for issuers in the oil and gas industry. In the Proposing Release, the SEC recognized 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 had become disconnected from industry practices and, therefore, of limited use to the market and investors. The Proposing Release was the subject of our Client Advisory dated July 3, 2008 which may be found at: <https://www.clm.com/publication.cfm/ID/188>.

On December 31, 2008, in Release No. 33-8995 (the "Adopting Release"), the SEC adopted the amendments, generally as proposed but with certain modifications prompted by some of the 65 comment letters received from interested persons. The Adopting Release may be found at <http://www.sec.gov/rules/final/2008/33-8995.pdf> and we urge you to refer to it for additional information.

The new requirements apply to "foreign private issuers"<sup>[1]</sup> as well as to "domestic issuers."

### Important Notes for Canadian Companies

The definitions and classifications used in Canadian National Instrument 51-101 form the basis, in large measure, for the new 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, as noted in our earlier Client Advisory and specifically confirmed in the Adopting Release, 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 meet their U.S. disclosure requirements by using their Canadian disclosure documents, which are prepared under Canadian law and practice. Hence, many of the changes to 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 Changes

**Timing of Pricing.** The amendments require that, for reserve reporting purposes, the price used in calculating the estimated value of reserves be the unweighted arithmetical average of the closing prices in effect on the first day of each month in the fiscal year (rather than the last day of each month contemplated in the Proposing Release). This replaces the existing rule that requires the price used to be the price in effect on the last day of the fiscal year. The reporting company may, at its option, include a reserves sensitivity analysis table that shows 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), provided that it also discloses the price and cost schedules and assumptions on which the alternate reserves estimates are based.

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**Prices Used for Accounting Purposes.** The Proposing Release contemplated the continued use of the single-day, year-end price 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)), notwithstanding the change mentioned above to the use of average prices in effect during the period for reserve reporting purposes. In response to objections to this approach in several of the comment letters, in the Adopting Release the SEC changed its position and amended the full-cost accounting rules to use a single price based on a 12-month average so as to be consistent with the reserve reporting modifications discussed above.

**Bitumen and Other Non-Traditional Resources.** The Adopting Release amends the definition in the SEC rules of “oil and gas producing activities” to include the extraction of saleable hydrocarbons, in the solid, liquid or gaseous state from oil sands and, provided that they are intended be converted into oil and gas, from shale, coalbeds or other non-renewable natural resources. Also included in the definition are activities undertaken with a view to such extraction and certain activities relating to the processing or upgrading of natural resources from which synthetic oil or gas can be extracted. In a departure from the Proposing Release, the new rules focus on the final product rather than on the method of extraction, so that the prices of synthetic oil and gas may be used to determine the economic producibility of the reserves for reserve estimation purposes.

**Definition of “Proved Reserves.”** The new rules make the definition of “proved reserves” 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 that there is a “high degree of confidence” that the quantities will be recovered. The “high degree of confidence” criterion was adopted in lieu of the criterion “much more likely to be achieved than not” that the SEC had proposed in the Proposing Release. The Adopting Release states that while the two criteria have, in the SEC’s view, the same meaning, the terminology was changed in response to suggestions in comment letters that it should be consistent with the language used in the Petroleum Resource Management System (a widely accepted standard developed by several organizations within the oil and gas industry). The new rules permit the use of either the “deterministic” or the “probabilistic” method for estimating reserves. These different methods are based on definitions contained in the Canadian Oil and Gas Evaluation Handbook. A “deterministic estimate” is one “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.” A “probabilistic estimate” is “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.” Where the deterministic method is used, the “reasonable certainty” requirement for proved reserves means a high degree of confidence that the quantities will be recovered. When the probabilistic method is used, the requirement is for at least a 90% probability that the quantities actually recovered will equal or exceed the estimate.

**Unproved Reserves (“Probable Reserves” and “Possible Reserves”).** The amendments permit the disclosure of unproved reserves (although such disclosure would be voluntary because it might involve increased risk of litigation). “Probable reserves” are reserves that, taken together with proved reserves, are as likely as not to be achieved. This means that, when deterministic methods are used, it is as likely as not that the actual remaining quantities recovered will equal or exceed the sum of estimated proved plus probable reserves and, when probabilistic methods are used, that there is at least a 50% probability that the actual quantities recovered will equal or exceed proved plus probable reserves estimates. “Possible reserves” are those that are less likely to be recovered than probable reserves. When deterministic methods are used, the total quantities actually recovered from the project have a low probability to exceed the sum of proved plus probable plus possible reserves; when probabilistic methods are used, there must be at least a 10% probability that the actual quantities recovered will equal or exceed the sum of proved, probable and possible reserves.

**Other Definitions.** We refer you to the Adopting Release (<http://www.sec.gov/rules/final/2008/33-8995.pdf>) for a discussion of a number of new or revised definitions of several other terms, including “reserves,” “developed oil and gas reserves,” “undeveloped oil and gas reserves,” “reliable

technology,” “bitumen,” and numerous supporting definitions. The Adopting Release also details a number of technical changes in other SEC rules to conform them to the modified regime of oil and gas disclosure.

**Disclosure Tables.** Despite some concerns raised in comment letters to the Proposing Release, the new rules 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 uncertainties related to the reserve estimates.

**Preparation of Reserve Estimates; Reserve Reports.** In the Proposing Release, 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. In the Adopting Release, objections to this approach that had been expressed in comment letters were rejected. As contemplated in the Proposing Release, the amendments 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. They also require that companies discuss in the document the internal controls that it uses to assure objectivity in the reserves estimation process and the qualifications of the technical person primarily responsible for preparing the reserves estimates. Additionally, where a company relies on a third party for reserves estimates, the new rules require that it 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 is for a summary report, rather than a full reserves report which is more detailed and can be voluminous.

**Additional Disclosures.** The Proposing Release contemplated the adoption of a new rule that would require a narrative description (either in the MD&A or in a separate section) of a specified list of topics (changes in prices, technical changes and changes in the status of concessions) that would supplement the reconciliation required by SFAS 69. Negative reactions to the rigidity of the proposed rule led the SEC to abandon it as a specific disclosure item. Instead, the Adopting Release sets forth a list of five topics 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.** The new rules (which we emphasize, once again, are not applicable to Canadian companies that file under MJDS) are 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. Companies may not elect to follow the new rules before the effective dates. The Adopting Release specifies that none of the new or amended rules requires retroactive revisions of past reserve estimates.

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**Endnote**

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

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