SEC Publishes Proposed Rule to Modify Oil and Gas Reporting Requirements

On June 26, 2008, the US Securities and Exchange Commission (SEC) published for public comment a proposed new rule governing the reporting of a company’s oil and gas reserves in SEC filings (Release No. 33-8935). In publishing the new rule proposal, the SEC has begun to address long-standing industry complaints over its inconsistent and anachronistic enforcement of Rule 4-10, Regulation S-X, with a complete overhaul of the existing rule. Industry members and others have 60 days in which to comment on whether the proposed rule has made the appropriate policy choices and provides sufficient flexibility to adapt to evolving technology.

The current rule, issued in 1978, permits oil and gas companies to disclose only “proved” oil and gas reserves. The 1978 rule defines proved reserves as that portion of a company’s oil and gas reserves that are “reasonably certain” of being produced under existing economic and operating conditions. Other categories of reserves, such as “probable” (and “possible”) reserves, which companies use in making investment decisions about whether and how to develop fields, were not permitted to be disclosed under the 1978 rule. Under the proposed rule, this would change.

The SEC’s proposed changes include:

- Changing from a single-day year end price to a 12-month historical average price for measuring reserves. This would provide more realistic price consideration than provided by a single-day spot price. However, although a historical average retains the SEC’s goal of promoting comparability between companies’ reserves disclosures, it has the disadvantage of not capturing management’s outlook on future prices or management’s planning prices used in making investment decisions. To address this, the proposed rule would permit companies, at their option, to also disclose analysis of the company’s total reserves estimate based on future prices, management’s planning prices, or other price schedules.

- Permitting the disclosure of hydrocarbon resources extracted from oil sands, coalbeds and shales, and other non-traditional resources. The SEC intends to shift the focus of the reserves definition from the extraction method employed in obtaining the hydrocarbons to the final product of certain extraction activities. For example, the proposed rule would permit bitumen from oil sands and coalbed methane to qualify as oil and gas reserves, but not coal gasification processes. This is because the SEC is concerned about comparability among coal mining companies for reporting purposes. However, the SEC has solicited comment on whether disclosure of coal extraction activities should be based on the end use of the coal rather than specific extraction methods.

- Adding a definition of “reasonable certainty” and explicitly allowing companies to disclose reserves under the probabilistic methodology. The term “reasonable certainty,” previously undefined, would be defined as “much more likely to be achieved than not.” The 1978 rule envisioned that
companies would disclose proved reserves pursuant to a single best estimate of the different variables that go into a company’s reserves estimate. However, oil and gas companies and the Society of Petroleum Engineers (SPE) have long employed probabilistic methodologies in estimating reserves. The proposed rule would explicitly permit the disclosure of reserves pursuant to the probabilistic method and benchmarks 90 percent probability as satisfying the “reasonable certainty” definition. This is consistent with the SPE definition.

- Permitting the use of new technology as the basis for determining reserves. The 1978 rule limited disclosure of reserves to those established by actual production or flow tests, except in the Gulf of Mexico—as noted in a letter from the SEC Staff to oil and gas companies in April 2004. This was a concession to the high costs of such tests in the Gulf’s deepwater fields and the fact that companies invest billions of dollars based on the use of alternative technologies to establish the existence of producible reserves. The proposed rule would permit the use of “reliable technology,” defined as technology that is widely accepted within the oil and gas industry and has demonstrated reliability. Consistent with this concept, companies could establish lowest known hydrocarbons through seismic interpretation or other reliable technical methods that provide information on fluid contacts and include within proved reserves oil and gas volumes beyond one offset from a developed drilling location if reserves in such areas are reasonably certain to be economically producible.

- Tightening project maturity requirements for proved reserves. Under the proposed rule, in order to include a project’s reserves as proved, the operator must have already started the project or the company must be reasonably certain that the project will commence within a reasonable time. This is a new requirement, not contained in the 1978 rule, and is designed to prevent companies from including as proved reserves projects in undeveloped areas that are not intended to be developed. The SEC is seeking comment whether there should be additional requirements, such as demonstrating a project’s financing commitments, before permitting a project’s reserves to be disclosed as proved.

- Disclosing additional categories of reserves, including “probable” and “possible” reserves. The proposed rule defines these additional categories and allows companies to decide on a voluntary basis whether to provide investors estimates of reserves recoverable at lower than “reasonable certainty” probability levels. The SEC’s objective is to allow companies to give investors insight into criteria that management may use in making investment decisions in resource development. The proposed rule would also require disclosure of the person or entity responsible for preparing the reserves estimates and performing any reserves audits.

The proposed rule is an ambitious and overdue step to overhaul the SEC’s oil and gas reserves disclosure regime. Unfortunately, this proposal came about only after serious disruption and concern in the oil and gas industry following Royal Dutch Shell’s 2004 restatement of more than 20 percent of its proved reserves portfolio. The company settled, on a no admission no denial basis, to securities fraud with the SEC and to market abuse with the UK Financial Services Authority (FSA) premised upon Shell’s alleged lack of adherence to the SEC Staff’s ad hoc guidance on proved reserves disclosure.
Over the ensuing years, Mayer Brown represented Sir Philip Watts, the former chairman of Shell, in DoJ, SEC, and FSA enforcement investigations and private class actions. In November 2005, the FSA announced that it had completed its investigation and that no action would be taken against Sir Philip. In August 2006, the SEC informed Sir Philip that it had terminated its investigation and that no action would be taken against him. On February 7, 2008, Sir Philip was dismissed from the class action.

Central to Sir Philip’s position in these matters was the fact that the SEC Staff had issued guidance and attempted to enforce its own views of the proper application of the 1978 rule, which were completely at odds with industry practice and evolving technology. The SEC’s proposed rule addresses many of the areas that were raised during the SEC’s and FSA’s investigations of Sir Philip and represents an important step in providing clarity and flexibility to a long neglected aspect of securities regulations in an industry crucial to the US and world economies.

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