

# US SEC Oil and Gas Reporting Rules

## Client Alert

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## Adoption by SEC of revised oil and gas reporting rules

### Background

On 29 December 2008, the US Securities and Exchange Commission ("SEC") adopted a set of final rules implementing a number of material amendments to SEC oil and gas reporting and disclosure requirements.

The revisions are intended to modernise the existing disclosure rules<sup>1</sup>, last updated by the SEC more than twenty-five years ago, to take into account new technologies and current industry practices. In addition, the SEC was concerned that investors should benefit from more meaningful and comprehensive disclosure to ensure that investment decisions are well-informed and based on accurate and relevant information.

The final rules are effective for registration statements filed on or after 1 January 2010 and for annual reports on Forms 10-K (for use by US domestic public companies) and 20-F (for use by foreign private issuers) filed in respect of financial years ending on or after 31 December 2009. Early compliance with the revised rules is not permitted and, to the extent that a company has a non-calendar financial year, that company will only be permitted to apply the new rules to its quarterly reports once it has filed its first annual report under the new rules.

### Summary of significant amendments

The most significant provisions and amendments contained within the newly adopted final rules are as follows:

- Companies will be permitted, but not required, to disclose probable and possible reserves, subject to certain criteria. Previously, such disclosure was generally prohibited.
- The definition of "reserves" has been broadened to include saleable hydrocarbons extracted from less conventional sources (e.g. oil sands,

<sup>1</sup> Existing disclosure rules are set out in Regulation S-K and Regulation S-X under the Securities Act of 1933 and the Securities Exchange Act of 1934, as well as Industry Guide 2 in Regulation S-K.

- coal and oil shale), taking into account developments in technologies and industry practice.
- A new test of "reliable technologies" can now be used in estimating proved reserves.
- Proved undeveloped reserves may be reported, notwithstanding their lack of immediate proximity to proved developed reserves, provided that there exists a reasonable certainty of "economic producibility" of the relevant reserves. Previously, the applicable test required that there was **certainty** of economic producibility from reserves located beyond the units immediately adjacent to those containing a producing well.
- Reserves will be priced on the basis of the 12-month average of the price for the relevant commodity on the first day of each month during the company's preceding fiscal year. This amendment is intended to mitigate potential distortions that result from the existing single-day, year-end pricing requirement.
- The SEC has provided comprehensive guidance as to topics that a company should consider including, to the extent material and relevant, in the MD&A section of its registration section or report.

#### **Amendments to scope of rules, definitions and concepts**

The new rules implement a number of revisions and additions to the definitions section of Rule 4-10(a) of Regulation S-X which are designed to reflect changes in the oil and gas industry and the introduction of new technologies that have occurred in the decades since the existing rules were adopted. The definitions have moved closer to those of the Society of Petroleum Engineers' Petroleum Resource Management System ("PRMS"), which are widely used and accepted in the oil and gas industry, and are seen as positive amendments for the SEC reporting regime. It is worth noting however that the final rules still differ significantly from the PRMS in several areas.

##### *Inclusion of reserves extracted from non-conventional sources*

Previously, the definition of "oil and gas producing activities" specifically excluded production of oil and gas from non-traditional or unconventional sources, such as bitumen extracted from oil sands and oil and gas extracted from coal and shale. The SEC recognised that these sources are becoming increasingly relevant in today's industry, in part due to advancements in extraction and processing technologies. As a result, the SEC has amended the definition of "oil and gas producing activities" to include these less traditional sources.

The amended definition expressly includes "extraction of saleable hydrocarbons, in the solid, liquid, or gaseous state, from oil sands, shale, coal beds, or other non-renewable natural resources, which are intended to be upgraded into synthetic oil and gas." Additionally, the definition includes activities related to the processing or upgrading of natural resources from which synthetic oil or gas can be extracted, such as transporting, refining, processing or marketing oil and gas and producing geothermal steam. The underlying intent here is to shift the focus to the final product, regardless of the method of extraction of that product.

### *Definition of reserves*

The term "reserves" is currently undefined in the existing rules. The new rules, however, define reserves for all categories – proved, probable or possible - as the "estimated remaining quantities of oil and gas and related substances anticipated to be economically producible, as of a given date, by application of development projects to known accumulations. In addition, there must exist, or there must be a reasonable expectation that there will exist, the legal right to produce or a revenue interest in the production of oil and gas, installed means of delivering oil and gas or related substances to market, and all permits and financing required to implement the project."

This definition is consistent with the PRMS definition, except that the PRMS definition states that the reserves must be "commercial", meaning that they must meet internal rates of return or other guidelines, rather than being "economically producible", requiring that the revenues exceed the costs of production.

### *Developed and undeveloped reserves*

The SEC has implemented a conceptual change related to developed and undeveloped reserves. In the past, only proved reserves were classified as "developed" or "undeveloped". However, in light of the SEC's decision to allow disclosure of possible and probable reserves (as discussed in further detail below), the final rules provide that the development status of the reserves, whether developed or undeveloped, is relevant to all classifications –proved, probable or possible – of oil and gas reserves.

Additionally, the new rules amend the "certainty" standard applicable to the definition of "proved undeveloped reserves". Previously, proved undeveloped reserves could only be reported as such if (i) there existed a reasonable certainty of economic producibility from reserves in a drilling unit adjacent to a unit containing a producing well, or (ii) there existed certainty of economic producibility from reserves in a drilling unit beyond those immediately adjacent to a unit containing a producing well. The amended rules now apply the 'reasonable certainty' test in both situations mentioned above.

Finally, the new rules prohibit classifying an undrilled location as a proved undeveloped reserve if a development plan has not been adopted to drill within the subsequent five years, unless an exception is granted. An exception to this prohibition would only be granted on the basis of specific circumstances justifying a longer period of time (e.g. significant costs or a remote site location).

### *Proved reserves*

#### *(i) Reasonable certainty of proved reserves*

In order for reserves to be classified as proved reserves, the new rules require that those reserves can be estimated with *reasonable certainty* to be economically producible. The new rules set out a definition of 'reasonable certainty', a term which was previously undefined, which permits the use of both deterministic methods and probabilistic methods in estimating reserves. If deterministic methods are used, reasonable certainty means a high degree of confidence that the quantities will be recovered. Consistent with the PRMS definition, if probabilistic methods are used,

there should be at least a 90% probability that the quantities actually recovered will equal or exceed the reserves estimate.

*(ii) Use of reliable technology*

Recognising that technology has developed, the SEC has adopted a new definition of "reliable technology" which can be relied upon to establish reasonable certainty in estimating proved reserves. Reliable technology is "a grouping of one or more technologies (including computational methods) that has been field tested and has demonstrated consistency and repeatability in the formation being evaluated or in an analogous formation." This development should be well received by the industry given that the technology does not have to be widely accepted nor pass a bright-line test, thus adding flexibility to the type of technology a company elects to use. It is worth noting that the SEC can request supplemental data to support a company's conclusion that the technology is "reliable".

*(iii) Pricing*

The definition of proved oil and gas reserves under both the current and new rules requires that the reserves be "economically producible" in the context of existing economic conditions. Under the existing rules, the commodity price to be used in determining whether this standard has been reached is the relevant single-day, year-end price for the commodity in question. The new rules amend the calculation of economic producibility to require use of "a 12-month average price, calculated as the unweighted arithmetic average of the first-day-of-the-month price for each month within the 12-month period prior to the end of the reporting period." This commodity pricing change is directed at increasing comparability between companies' oil and gas reserve disclosures, while mitigating any additional variability that a single-day price may have on reserve estimates.

*'Probable' and 'possible' reserves*

Under the new rules, companies are permitted, but not required, to disclose 'probable' and 'possible' reserves. Previously, such disclosure was generally prohibited.

Additionally, the SEC has adopted new definitions of "probable reserves" and "possible reserves" as follows:

	<b>Certainty standard</b>	<b>Deterministic method</b>	<b>Probabilistic method</b>
<b>Probable reserves</b>	Reserves that are less certain to be recovered than proved reserves but which, when added to proved reserves, are as likely as not to be recovered	As likely as not that actual remaining quantities recovered will equal or exceed the sum of estimated proved plus probable reserves estimates	At least a 50% probability that the actual quantities recovered will equal or exceed the sum of estimated proved plus probable reserves estimates
<b>Possible Reserves</b>	Reserves that might be recovered but that are less certain to be recovered than probable	Low probability that the total quantities ultimately recovered from a	At least a 10% probability that the actual quantities recovered will equal or exceed the sum of

	reserves	project will exceed the sum of proved, probable, and possible reserves estimates	proved, probable, and possible reserves estimates
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While the option to disclose probable or possible reserves is available, if a company discloses these reserves, it must state whether they are developed or undeveloped and must disclose the relative uncertainty associated with these categories of reserves, as discussed below.

### **New disclosure requirements**

The final rules repeal SEC Industry Guide 2 and substitute a new Subpart 1200 of Regulation S-K in its place, the text of which largely mirrors the existing disclosure requirements, subject to certain additions and enhancements. The requirements set out in Subpart 1200 are aimed at providing better clarity with respect to the level of detail to be included in the oil and gas disclosures and also to provide formats for tabular presentation of the necessary information.

#### *Geographical area*

The new rules set down a general requirement for disclosure of a company's reserves by geographic area on an individual country, groups of countries within a continent, or continent basis, whichever is deemed to provide the most meaningful disclosure for investors.

Originally, the SEC had proposed requiring a far greater level of detail and breakdown in the geographic context, including a requirement to disclose sedimentary basins or fields containing 10% or more of the company's reserves. During the consultation process on the new rules, the SEC noted that numerous commentators had raised concerns that the increased level of detail would make disclosures too complex and incoherent and may also pose a threat to competition in the market in the context of future asset sales transactions.

The SEC took such concerns into account and reduced the level of detail set out in the new rules to require specific disclosure of the following:

- production in each country or field containing 15% or more of the company's proved global oil or gas reserves (unless prohibited by the country in which the reserves are located); and
- reserves in each country containing more than 15% of the company's proved global oil or gas reserves (unless prohibited by the country in which the reserves are located).<sup>2</sup>

#### *Disclosure tables*

The SEC noted in the final rules that it considers that tabular presentation of the required disclosures improves the readability and comparability of disclosures among oil and gas companies.

<sup>2</sup> The final rules do not require a company to break-down its reserves estimates by sedimentary field or basin.

The rules therefore provide that disclosure in tabular format is required for proved developed, proved undeveloped and total proved reserves. Each reserve category included in the table must be presented by geographic area and final product (specifically, oil, gas, synthetic oil, synthetic gas, or other natural resource).

To the extent that the company chooses to include probable and possible developed and undeveloped reserves in these tables, it must provide the same level of geographic and final product detail as required for proved reserves. In addition, in the case of possible and probable reserves, a company must disclose the relative uncertainty associated with these classifications of reserves estimates.

In estimating its reserves, and as explained in more detail above, a company must determine whether its oil and gas resources are economically producible based on a 12-month average price for the relevant commodity. However, the new rules also entitle a company to include an optional reserves sensitivity table as a means of disclosing to investors how reserves estimates may differ if calculations were based on different price and cost schedules, thereby highlighting oil and gas reserves' sensitivity to price fluctuations. If included, the optional reserves sensitivity table must be accompanied by a list of underlying assumptions on which the different price and cost scenarios are based so as not to mislead investors.

#### *Preparation of estimates and conduct of audits*

In order to assist investors in determining whether reserves estimates have been prepared by a suitably qualified and objective person, the final rules include a new requirement for a company to provide a general overview of internal controls in place within the company in the context of the reserves estimation process. In addition, the company must disclose the qualifications of the technical person primarily responsible for preparing an estimate or conducting an audit of reserves, regardless of whether such person is an employee of the company or an external third party.

In addition, any third party report produced in the course of preparing or auditing the reserves estimate should be disclosed as an exhibit to the company's SEC registration statement or report. Given that the full third party reports are often very detailed and lengthy, a company need only file a shorter form report which summarises the scope of work performed by, and the conclusions of, the third party.

#### *Proved undeveloped reserves*

The new rules include a requirement to disclose the following information with respect to a company's proved undeveloped reserves:

- the total quantity of a company's proved undeveloped reserves at year end;
- any material changes in these proved undeveloped reserves during the year, including the conversion of any proved undeveloped into proved developed reserves;
- investments and progress made during the year in relation to the conversion of proved undeveloped into proved developed reserves; and
- an explanation as to why any proved undeveloped reserve remains undeveloped for a period of five years or more from first disclosure.

### *Reliable technologies*

For a company that has not previously disclosed reserves estimates or is making a material addition to previous reserves estimates, the final rules require that company to provide a general summary of technologies relied upon to establish the level of certainty required to report such reserves.

### *Oil and gas production table*

The new rules include the existing requirement for a company to disclose its prior three years of oil and gas production by final product sold. However, as described in more detail above, such production disclosure must now be made by geographic area and should set out the average sales price per unit of oil, gas and other products produced and the average production cost per unit produced.

### **MD&A Guidance**

In addition to amending the oil and gas reporting rules, the SEC has provided guidance relating to the information that oil and gas companies should consider providing in the Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"). The SEC has suggested that a company should consider including discussion on the following areas where relevant:

- changes in proved and, if disclosed, probable and possible reserves and the sources for such changes;
- technologies used to determine the appropriate level of certainty for material additions to, or increases in, reserves estimates and the bases for such changes (price, technical revisions, etc.);
- prices and costs, including the impact on depreciation, depletion and amortization as well as the full cost ceiling test;
- performance of currently producing wells, including water production from such wells and the need to use advanced recovery techniques to continue production;
- performance of any mining-type activities for the production of hydrocarbons;
- any recent conversions of proved undeveloped reserves to proved developed reserves and, if disclosed, discussion of conversion of probable to proved reserves and possible to probable or proved reserves;
- minimum term remaining for relevant concessions and leases;
- material changes to any line item in the tabular disclosures required under new rules;
- potential effects of different forms of rights to resources, such as production sharing contracts, on operations; and
- geopolitical risks that may impact material concentrations of reserves.

## Foreign Private Issuers

In order to ensure consistency between US and foreign oil and gas companies reporting to the SEC, the final rules are made applicable to foreign private issuers<sup>3</sup> by virtue of parallel amendments made to Form 20-F, the form used by foreign private issuers to file their registration statements and annual reports. The foreign issuers will however still be permitted to exclude certain disclosures from their SEC filings to the extent that such disclosures are prohibited by the laws and regulations of their home country.

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<sup>3</sup> A "foreign private issuer" means, under Rule 405 of the Securities Act of 1933, any foreign issuer, other than a foreign government, except an issuer that meets the following conditions: (i) more than 50 percent of its outstanding voting securities are directly or indirectly owned of record by residents of the United States and (ii) any of the following: (a) the majority of the executive officers or directors are United States citizens or residents; (b) more than 50 percent of the assets of the issuer are located in the United States; or (c) the business of the issuer is administered principally in the United States.