

Securities Update

SEC Proposes Modernization of Oil and Gas Reporting Requirements

Overview

The US Securities and Exchange Commission (the "SEC") recently published proposed revisions to its oil and gas reporting requirements.¹ The revisions are intended to provide investors with a more meaningful and comprehensive picture of the oil and gas reserves that a company holds. The revisions are also intended to address concerns that existing disclosure requirements, which were originally adopted in 1978 and 1982, do not reflect current industry practices and technological changes in the oil and gas industry.

The key changes proposed are as follows:

- Companies will be permitted to disclose "probable" and "possible" reserves (in addition to "proved" reserves).
- The definition of reserves will be revised to reflect industry practices and expanded to include "non-traditional" and "unconventional" sources, such as bitumen extracted from oil sands, and oil and gas extracted from coalbeds and shales.
- Reserves will be valued based on a 12-month average price, rather than a spot price at the end of the fiscal year.
- A wider range of "reliable technologies" will be permitted to determine the existence of reserves.
- Companies will be required to provide enhanced disclosure regarding their reserves and to file third-party reports on which they have relied in determining their reserves.

The new rules are proposed to be effective for registration statements filed on or after January 1, 2010, and for annual reports on Forms 10-K and 20-F for fiscal years ending on or after December 31, 2009. The revised standards are proposed to apply to domestic issuers and foreign private issuers alike with only limited exceptions for foreign private issuers. The SEC is accepting comments on the proposed rules until September 8, 2008.

The proposed rules are discussed in greater detail below.

¹ *Modernization of the Oil and Gas Reporting Requirements*, Release Nos. 33-8935; 34-58030 (June 26, 2008). This follows the SEC's *Concept Release on Possible Revisions to the Disclosure Requirements Relating to Oil and Gas Reserves*, Release Nos. 33-8870; 34-56945 (December 12, 2007)

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Guidance by Existing Regulatory Frameworks

The new disclosure framework proposed by the SEC is guided significantly by Canadian National Instrument 51-101 (NI 51-101), which was adopted in 2003, and governs the Canadian regulatory system for oil and gas company disclosures. This, in turn, draws upon the Petroleum Resources Management System (PRMS), a classification system that defines a broad range of reserves categories, such as “contingent resources” and “prospective resources.” The PRMS classifications are broadly used as references in the oil and gas industry. Nevertheless, the proposed rules diverge in significant ways from these standards in order to maintain comparability among different companies’ reserves disclosures, which is a guiding principle in the proposed SEC disclosure regime.

Proposed Changes

Definition of Reserves

The SEC is proposing to use the PRMS definition to define “reserves” as the estimated remaining quantities of oil and gas and related substances anticipated to be recoverable, as of a given date, by application of development projects to known accumulations based on:

- Analysis of geoscience and engineering data
- The use of “reliable technology”
- The legal right to produce
- Installed means of delivering the oil, gas or related substances to markets or the permits, financing and the appropriate level of certainty to do so
- “Economic producibility” at current prices and costs

The definition would classify reserves as “proved,” “probable” or “possible” based on the degree of certainty associated with the estimates.

Non-Traditional and Unconventional Sources

The proposed rules would allow companies to disclose oil and gas reserves from “non-traditional” and “unconventional” sources, such as coalbeds and shales, as well as bitumen from oil sands. In particular, the SEC is proposing to amend the definition of “proved developed oil and gas reserves” to reflect the fact that oil and gas can be extracted through technology other than traditional wells.

This proposal reflects an increased focus on disclosure based on the final products (e.g., oil and gas), rather than the particular extraction technology. In soliciting comments, the SEC notes in particular the challenge of classifying coal extraction due to the fact that coal is generally used for energy production, rather than for the extraction of further hydrocarbons. Applying a definition based on the end use of the coal could result in different disclosures for otherwise similar coal-mining companies.

Proved Reserves, Probable Reserves and Possible Reserves

The current definition of proved reserves is “the estimated quantities of crude oil, natural gas and natural gas liquids, whose geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions.” The proposed new definition of proved reserves are reserves “(i) in projects that extract oil and gas through wells, can be expected to be recovered through existing wells with existing equipment and operating methods; and (ii) in projects that extract oil and gas in other ways, can be expected to be recovered through extraction technology installed and operational at the time of the reserves estimate.” In order for reserves to be considered proved, the project to

extract the hydrocarbons must have commenced, or it must be reasonably certain that the operator will commence the project within a reasonable time. Proved reserves can therefore only be from areas that the company has a specific intent to develop.

The SEC is also proposing to permit, but not require, companies to disclose probable and possible reserves. Many companies currently disclose this information on their websites and in press releases, but current SEC rules limit disclosure in filings to proved reserves. The proposed rules would require companies electing to disclose this information to disclose the relative risks related to the accuracy of such reserves estimations. The proposed new definitions of these terms are based on the PRMS definitions. The following table summarizes certain clarifications proposed by the SEC to the current definition of proved reserves and the SEC's proposed new definitions of probable and possible reserves:

"Deterministic" and "probabilistic" methods are two alternative means of estimating reserves. The SEC is not mandating one method over the other. A "deterministic estimate" is based on 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 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.

Under the proposed rules, the SEC would continue to prohibit disclosure of estimates of oil and gas resources other than those falling into the categories described above, unless required by foreign or state law, or to an acquirer in connection with an acquisition.

	Proved Reserves	Probable Reserves	Possible Reserves
Confidence level	Reasonable certainty, defined in the proposed rules as much more likely to be achieved than not.	Additional reserves that are less certain to be recovered than proved reserves but which, in sum with proved reserves, are as likely as not to be recovered.	Additional reserves that are less certain to be recovered than probable reserves.
Deterministic method	Reasonably certain estimated ultimate recovery (defined as the sum of reserves remaining as of a given date plus the cumulative production as of that date) must be much more likely to increase than to either decrease or remain constant.	As likely as not that actual remaining quantities recovered will equal or exceed the sum of estimated proved plus probable reserves.	Total quantities ultimately recovered from a project have a low probability to exceed the sum of proved, probable, and possible reserves.
Probabilistic method	At least a 90 percent probability that the quantities actually recovered will equal or exceed the stated volume.	At least a 50 percent probability that the quantities actually recovered will equal or exceed the proved plus probable reserves estimates.	At least a ten percent probability that the total quantities recovered will equal or exceed the sum of proved, probable, and possible estimates.

Use of New Technologies to Determine Reserves

Under current rules, a company can generally meet the “reasonable certainty” standard necessary to establish proved reserves only by using actual production or flow tests. However, flow tests are not permitted in all regions and, in addition, new tests are likely to develop as a result of improvements in technology. Therefore, under the proposed rules, the SEC will permit the use of a test based on “reliable technology” to establish reserves. “Reliable technology” is defined as “technology (including computational methods) that, when applied using high-quality geoscience and engineering data, is widely accepted within the oil and gas industry, has been field tested and has demonstrated consistency and repeatability in the formation being evaluated or in an analogous formation. Consistent with current industry practice, expressed in probabilistic terms, reliable technology has been proved empirically to lead to correct conclusions in 90 percent or more of its applications.” The particular technology used by a company and the reserves for which it was used must be disclosed in the company’s first filing containing reserves estimates or material additions to reserves estimates.

In keeping with the ability to use alternative technologies, the proposed definition of proved reserves includes provisions for establishing levels of lowest-known hydrocarbons and highest-known oil through “reliable technology” in addition to well penetrations, which is the method required by the current rules.

Definition of “Proved Undeveloped Reserves”

The definition of “proved undeveloped reserves” currently imposes a “reasonable certainty” standard for reserves in drilling units immediately adjacent to the drilling unit containing a producing well and a “certainty” standard for reserves in

drilling units beyond the immediately adjacent drilling units. The SEC is proposing to apply a reasonable certainty standard in both cases. The SEC is also proposing to clarify that proved reserves can be in a conventional accumulation (e.g., discrete accumulations resulting from geographic features typically overlaying water) or a continuous accumulation (e.g., accumulations, such as oil sands and oil shale deposits, that are not limited to a discrete area and generally do not overlay water) in a given area beyond immediately offset drilling units where economic producibility is reasonably certain, based on engineering, geoscience, and economic data and reliable technology, including actual drilling statistics in the area. The SEC, however, would prohibit classifying an undrilled location as proved if a development plan to drill within the subsequent five years has not been adopted. An exception to this prohibition would only be granted in unusual circumstances justifying a longer period of time, such as for particularly complex projects located in remote areas requiring more time to develop.

Valuation Methodology

Under the proposed rules, companies would be required to value oil and gas reserves in order to determine whether they are “economically producible” using an average price during the company’s fiscal year, rather than a spot price at year end. This would be calculated using the unweighted arithmetic average of the closing price on the last day of each month in that 12-month period. The SEC believes that this will maximize the comparability of reserves estimates among companies and mitigate the risk of distortion that arises when using a single pricing date. This valuation methodology is different from that used in NI 51-101 and PRMS, which allow more flexibility in pricing methodology subject to appropriate disclosure.

2 The two methods of accounting are the “successful efforts” method set forth in Statement of Financial Accounting Standard No. 19 (SFAS 19) prescribed by the Financial Accounting Standards Board (FASB) or the full cost accounting method set forth in Rule 4-10(c)4 of Regulation S-X.

Because disclosure based solely on historical prices will not capture management's outlook on the future or futures prices, a company will be permitted to include a sensitivity analysis that shows total reserves estimates based on futures prices, management's planning prices or other price schedules in addition to the 12-month historical average.

"Economically producible" means that the estimated revenues must exceed costs. This is also different from NI 51-101 and PRMS, which require extractive projects to be "commercial," meaning that it must meet internal rates of return or other guidelines.

The SEC notes that the above change to valuation methodology for securities disclosure purposes does not change applicable accounting standards, which, for example, require depreciation of property, plant and equipment using a units-of-production basis over proved developed reserves or proved reserves, as applicable, using the single-day, year-end rate.² The SEC intends to discuss the conflict in methodologies with the Financial Accounting Standards Board (FASB). In the meantime, the SEC notes that for the purpose of Statement of Financial Accounting Standard No. 69 (SFAS 69), Disclosures about Oil and Gas Producing Activities, companies should use the weighted arithmetic average price method described above.

New and Enhanced Disclosure Requirements

The proposed rules would codify the required disclosures for SEC filings in a new Subpart 1200 to Regulation S-K, which would replace Industry Guide No. 2. The following is a summary of the new and enhanced disclosures proposed by the SEC. Existing requirements from Industry Guide No. 2 that are merely proposed to be codified are not discussed below.

Oil and Gas Reserves Disclosure Tables (Item 1202)

Companies would be required to include a combined table or two separate tables for conventional accumulations and continuous accumulations showing (i) proved developed reserves, (ii) proved undeveloped reserves and (iii) total proved reserves. In addition, companies would be able to elect to include probable and possible reserves as stated above. Under the proposed rules, companies would be able to present information on a continent-only basis unless a particular country contained 15 percent or more of the company's global oil reserves or gas reserves. Similarly, a particular sedimentary basin or field would have to be disclosed separately if it contained 10 percent or more of a company's global oil reserves or gas reserves.

As discussed above, the determination of economic producibility would be based on a 12-month average of historical prices. However, the SEC is proposing to permit companies to include an optional reserves sensitivity analysis table in their filings that would show what the reserves estimates would be if 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.

Disclosure Regarding Conduct of Estimates and Audits (Item 1202)

The proposed rules require companies to disclose the following:

- If a reserves estimate was conducted by a company employee, the employee's responsibility in preparing the estimate must be disclosed (with no requirement to disclose the employee's specific identity), along with the measures taken to ensure the estimate's objectivity and independence.

- If a reserves estimate or reserves audit was conducted by a person who is not a company employee, the person's identity, a description of the nature and cost of all services that person has performed for the company in the prior three fiscal years (excluding other reserves estimates or reserves audits performed), and any interest that person may have in the company or other conflict of interests must be disclosed.
- In all cases of a reserves estimate or reserves audit, a company must disclose whether the person primarily responsible for the estimating or auditing of reserves (i) has certain prescribed minimum levels of experience, (ii) possesses certain educational and professional qualifications and (iii) is a member in good standing of a self-regulatory organization of engineers, geologists, other geoscientists or other professionals, whose professional practice includes reserves evaluations or reserves audits.

Filing of Audit Report (Item 1202)

Companies would be required to file as an exhibit to their registration statement or report any third-party report that they represent they have relied upon in determining their reserves. Similarly, if a third party conducted a reserves audit of a company's reserves estimates, the company would be required to file the third-party report as an exhibit to the relevant registration statement or report. The SEC has proposed certain mandatory content for these reports, based on guidance issued by the Society of Petroleum Evaluation Engineers.

Table of Conversion of Proved Undeveloped Reserves (Item 1203)

The proposed rules would require companies to include a table showing, for each of the last five fiscal years and by product type, proved undeveloped reserves converted to proved developed reserves during the year and the net investment, required to convert proved undeveloped reserves to proved reserves during the year.

Table of Oil and Gas Production (Item 1204)

The proposed rules would require the inclusion of a table (customarily included by most filers in any event) disclosing oil and gas production by geographic area.

Table of Drilling and Other Exploratory and Development Activities (Item 1205)

The proposed rules would require the inclusion of a table disclosing the geographic location of exploratory, development, extension and suspended wells. The SEC has added the requirement to disclose extension wells as distinct from exploratory wells because the latter tend to relate to new fields. The SEC believes that disclosure of suspended drilling is helpful to investors because of the significant capital investment that can be involved.

Oil and Gas Properties, Wells, Operations and Acreage (Item 1208)

The proposed rules would require a more detailed description of the properties and facilities of an oil and gas company. They would require tabular disclosure by geographic area of (i) the gross and net number of producing wells and (ii) the company's total gross and net developed and undeveloped acres, including leases and concessions. Finally, because the SEC has expanded the definition of oil and gas producing activities to include non-traditional resources, companies that extract hydrocarbons through means other than wells are required to provide a discussion of the techniques used in such operations. Specifically, this would require disclosure of the existence, nature (including any bonding requirements), timing and cost (specified or estimated) of any work commitments and the net area of unproved property for which the registrant expects its rights to explore, develop and exploit to expire within one year.

MD&A (Item 1209)

The proposed rules would require discussion of the following:

- Changes in proved reserves and, if disclosed, probable and possible reserves, and the basis for such changes (e.g., price, technical revisions, changes in status of concessions, etc.);
- Technologies used to establish the level of certainty for material changes to reserves estimates;
- Items relevant to a company's discussion of factors reasonably likely to materially affect the company, such as known trends, demands, commitments, uncertainties and events.

The SEC believes that the above items are already required generally in MD&A.

Application to Foreign Private Issuers

The SEC proposes that Form 20-F's provisions titled "Appendix A to Item 4.D—Oil and Gas," which provide guidance for oil and gas disclosures for foreign private issuers, be replaced by new Subpart 1200 to Regulation S-K. This would result in the imposition on foreign private issuers of the same disclosure requirements that are proposed to be imposed on domestic issuers. However, the SEC is proposing to retain the provision that currently allows a foreign private issuer to exclude required disclosures about reserves and agreements if its home country prohibits such disclosures.

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