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## SEC Issues New Reserve Reporting Requirements

On December 29, 2008, the U.S. Securities and Exchange Commission (“**SEC**”) released revisions to its reserve reporting requirements. The new rules are effective as of January 1, 2010, and early compliance is not permitted. The January 2010 effective date is expected to provide the SEC sufficient time to work with the Financial Accounting Standards Board to conform the new rules with reserve definitions used for financial statement purposes. Without this conformity, investors might be confused by the use of different numbers in the financial statements and in the text of an SEC filing.

These changes are the first major modification to the accounting-based SEC reserve reporting requirements since 1982. The new rules attempt to provide investors with a more complete picture of the reserves of reporting companies by recognizing the technologies and reserve quantification methods that have emerged and developed over the last several decades.

### New Regulations and Comments

- *Proved Reserves and “Reasonable Certainty.”* Under current rules, companies must use actual production or flow test data to meet the “reasonable certainty” standard to establish proved reserves. Under the new rules, however, new technologies are allowed to prove reserves if the technologies have been empirically demonstrated to be reliable in establishing reserves in the specific area. While proprietary details of the new technology do not have to be revealed, a succinct description of technologies used when the reserves are first booked must be disclosed.
- *Proved Undeveloped Reserves.* Under the new rules, the definition of proved undeveloped reserves has been changed to account for future changes in technology and to permit the classification of reserves as proved (or, as described below, probable or possible reserves) even if they are not adjacent to existing wells. In addition, while the SEC originally envisioned a five-year limit on classifying undeveloped reserves as proved, under the new rules companies will be able to include proved undeveloped reserves for longer than five years provided that they describe the circumstances that have or are expected to delay development, such as pipeline completion dates longer than five years from the time of the report.
- *Unconventional Sources of Oil.* Under current SEC rules, only conventional sources of reserves may be reported as proved. Since 1982, however, new technologies have made the production of unconventional sources of hydrocarbons, such as oil tar sands, economic and viable alternatives to traditional plays. Under the new rules, companies will be able to disclose these deposits as reserves.
- *P-3 Reporting.* Under current SEC rules, only estimates of proved reserves may be included in SEC reports. Under the new rules, companies, at their option, may include estimates of probable and possible reserves in their SEC reports. The definitions used for each of these reserve categories are similar to the reserve definitions already used by both the Society of Petroleum Engineers and the Canadian regulatory authorities. This is expected to provide shareholders and other investors with more complete disclosure related to companies’ capital expenditure decisions and development plans.

- *Price Sensitivity Analysis.* Under the new rules, companies may provide tabular disclosure of the sensitivity that their reserve estimates have to price fluctuations. While the SEC did not mandate a range of prices that companies must use, companies will be required to provide disclosure of the assumptions underlying the varying reserve estimate scenarios. The sensitivity analysis disclosure will be especially important in times of high price volatility, as it will provide investors greater insight into the effects of potential future prices on reserves.
- *Twelve-Month Average Pricing.* Rather than basing the economically producible price on the last day of the year as the current rules mandate, the new rules provide that the price used for existing economic conditions will be a twelve-month average, using an unweighted average of the price on the first day of each month. Accordingly, the new rules are expected to enhance inter-company comparability, while dampening the effects of short term volatility and seasonality. Alternatively, reported prices can be based on existing contractual arrangements.
- *Contents of Third-Party Reserve Reports, Qualifications of Evaluators and Corporate Objectivity.* If a company uses a third party to prepare their reserve estimates, the new rules provide that the company must include a report that summarizes the tasks performed and the conclusions reached by such third party. The new rules contain a checklist of specific items to be included in the report, such as the proportion of the company's reserves covered by the report and their location, and the methodology and assumptions that went into making the reserve calculations.

Whether or not a third party prepares the company's reserve estimates, the new rules require disclosure of the reserve engineer's qualifications. While the new rules do not require third-party reserve estimates, a general discussion describing the safeguards maintained to protect the objectivity and integrity of the company's reporting process must be included in the reserve report whether a third party is used or not.

The new rules are expected to result in an increase in reserves reported in SEC filings. Some reserve evaluators predict that the sudden emergence of these larger numbers—seemingly with the endorsement of the SEC—will result in market instability by attracting investors who lack the experience or inclination to look behind the numbers and understand their speculative nature. While the exact effects of the rule changes are unknown, it's possible the SEC may eventually tighten the rules, particularly those relating to disclosures of possible reserves.

For further comment and analysis, please look for our article on the new SEC reserve reporting requirements in the upcoming *Bloomberg Law Reports* in February.

[Christopher S. Kulander](#)

713.547.2067

[chris.kulander@haynesboone.com](mailto:chris.kulander@haynesboone.com)

[William B. Nelson](#)

713.547.2084

[bill.nelson@haynesboone.com](mailto:bill.nelson@haynesboone.com)

[Bruce Newsome](#)

214.651.5119

[bruce.newsome@haynesboone.com](mailto:bruce.newsome@haynesboone.com)