New SEC Concept Floated to Change Way E&P Companies Book Reserves

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Topic: Alternative energy

The SEC, with little fanfare, has posted a "Concept Release" on possible changes to oil and gas reserve disclosure. The pdf can be dowloaded here. Johnson Rice, one of my favorite energy research shops, had the following to say about this 'curious' SEC release:

> Bottom line: The SEC has been reviewing its reserve booking rules for some time now and this Concept Release is a step in that process. The document does not contain formal rule changes or recommendations, but the direction the SEC is heading is clear. The current rules were last updated back in 1982 and fail to take into account the development of vast resource plays and the technological advances that have been made in the industry. While many industry players stand to benefit, the biggest impact will be for the onshore companies with large acreage positions in resource plays such as shale plays or coal bed methane. A change in the booking rules will potentially allow companies to book significantly more proved reserves than are allowed today. This will ripple through the E&P space in terms of higher NAV's based on higher proved reserves. This will also impact acquisition economics as acquirers can point to a higher level of proved reserves being acquired to justify the price, not just 2P or 3P potential the acreage may contain.

Again, from Ken Carroll at Johnson Rice:

> A couple of points to note in the SEC document below:
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> § First, keep in mind that this is a conceptual document that is seeking public comment. As you read through it, there is little detail and no real recommendations for changes to the reserve booking rules, simply a lot of questions about why things are done the way they are today and if they should be changed given the technology advances we have seen and the nature of much of the drilling today.
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> § Starting on page five, the document outlines the current definition of proved reserves and some of the strict interpretations that the SEC has used in allowing companies to book proved oil and gas reserves.
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> § As part of this discussion, the concept paper lays out current rules allowing companies to book only immediately adjacent locations. It is clear that this interpretation, which

may have been perfectly valid back in 1982, is no longer relevant in today's world of resource plays, particularly shale and coal bed methane plays, and that the SEC strongly considering changing this. The idea is that what most companies consider Probable or 2P reserves in these resource plays have the same risk profile as that immediately adjacent PUD location.

§ Page nine begins a discussion of the technological advances, including 3-D and 4-D seismic, that have occurred since the last major change to reserve booking rules back in 1982. It also notes how the rules do not include "the extraction of hydrocarbons from shale, tar sands or coal." This has implication for both gas resource plays and oil and tar sand developments.

§ Finally, the piece notes that the Society of Petroleum Engineers released a revised reserve classification framework in February 2007, which defines "a broad range of reserves categories, contingent resources and prospective resources", and that this framework is used by companies and investors for private financing transactions…

§ The document then requests comments on a broad range of topics including whether the SEC replace the current reserve disclosure guidelines and what form that should take. Should companies be allowed to report reserves other than proved reserves? Should the definition of proved reserves be changed?

My take

If this floated rule 'passes', and I am hearing that it eventually will, I see 3 implications:

1)In a financial world where credit is increasingly dear, it will make it easier for energy companies to borrow money - what originally was 100 million in proved reserves is now 200 million. Banks will give loans to real assets. Good? timing.

2)US proved reserves will increase, which might politically look good, since we peaked in production in 1970 and all that.

3)There will be a surge in prices in companies that now can sign off on higher reserves (that started to happen today IMO). Of course, in the evolutionary arms race that is Wall St, the 'buyers' of these companies will gradually change the metrics by which they evaluate companies, and we'll eventually be right back where we started.

An accounting game, but with some short term financial winners. Sadly, the SEC, cannot magically create oil. Now the Federal Reserve however....

Thoughts welcomed.