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New SEC Oil Accounting Rules

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On December 29, the SEC announced updated accounting rules for oil and gas companies. The new rules are expected to be effective a year from now, with financial statements issued December 15, 2009, and subsequent. Full details are not yet available, but in general, the new rules allow companies to make greater consideration of technology in setting reserves. The SEC will also allow companies to disclose probable and possible reserves to investors, in addition to proven reserves. A third change is that average prices during the previous twelve months will be used, instead of prices as of the statement date.

According to the SEC's press release:

> The new disclosure requirements approved by the Commission include provisions that permit the use of new technologies to determine proved reserves if those technologies have been demonstrated empirically to lead to reliable conclusions about reserves volumes. The new requirements also will allow companies to disclose their probable and possible reserves to investors. Currently, the Commission's rules limit disclosure to only proved reserves.
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> The new disclosure requirements also require companies to report the independence and qualifications of a reserves preparer or auditor; file reports when a third party is relied upon to prepare reserves estimates or conducts a reserves audit; and report oil and gas reserves using an average price based upon the prior 12-month period rather than year-end prices. The use of the average price will maximize the comparability of reserves estimates among companies and mitigate the distortion of the estimates that arises when using a single pricing date.

Full details are not yet available. This summer, the SEC announced proposed rule changes. It is not known whether today's announcement will match exactly. Details will be announced later. The proposed rule changes were

> • Permitting use of new technologies to determine proved reserves if those technologies have been demonstrated empirically to lead to reliable conclusions about reserves volumes.
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> • Enabling companies to additionally disclose their probable and possible reserves to investors. Current rules limit disclosure to only proved reserves.

> • Allowing previously excluded resources, such as oil sands, to be classified as oil and gas reserves. Currently these resources are considered to be mining reserves.
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> • Requiring companies to report the independence and qualifications of a preparer or auditor, based on current Society of Petroleum Engineers criteria.
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> • Requiring the filing of reports for companies that rely on a third party to prepare reserves estimates or conduct a reserves audit.
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> • Requiring companies to report oil and gas reserves using an average price based upon the prior 12-month period-rather than year-end prices, to maximize the comparability of reserve estimates among companies and mitigate the distortion of the estimates that arises when using a single pricing date.

It is expected that the new rules will become effective with financial reports a year from now--those filed on or after December 15, 2009.

Observations

Financial statements prepared as of December 31, 2008, based on current accounting rules are likely to look pretty bleak. Not only are oil and gas prices much lower, but reserves based on these lower prices are likely to be lower as well, since at a lower price, less oil or gas may be economically recoverable. If the new accounting rules do not become effective for another year, they will not immediately help the financial statement problems of oil and gas companies.

Using average prices in the future will help smooth out volatility. This is good from a stability point of view, but can have a positive or negative impact for any given year. If the new rules were in effect for statements effective December 31, 2008, oil and gas companies could have used a much higher price for valuing reserves at December 31, 2008, which would have been helpful to balance sheets. Next year, it is quite possible that the opposite effect will take place. Oil prices are low now, but could very well rise by the end of next year. If this happens, using a 12-month average price will penalize companies for low prices now.

One of the problems with lower oil prices is the impact they have on the ability of companies to amortize unsuccessful exploration costs. It is expected that by averaging prices over a 12-month period, the "ceiling test" (which is applied each quarter-end and has the effect of limiting this amortization), will have less impact. This is an article regarding how the ceiling test works. Of course, if the new rules are not effective until next year and prices are very low for December 31, 2008, statements, ceiling test write-downs are still likely to be a problem this year-end.

Under the new regulations, companies will be able to consider reserves to be proved if reserves can be demonstrated using modern technology, instead of actually having to drill test wells to prove the existence of the reserves. According to the statement, new technologies are permitted "if these technologies have been demonstrated empirically to lead to reliable conclusions about reserve volumes." It seems likely this new rule will be interpreted to permit the use of 3D seismic imaging in determining reserves. It may also allow consideration of the impact of fracturing techniques in estimating reserve amounts. This rule change is should be beneficial to oil and gas companies, since proved reserves are likely to be higher with the expanded definition of what is proved. Implementation of the rule should provide a one-time increase in proved reserves. Also, new discoveries are likely to be booked more quickly in the future, since the amount of a new discovery can be estimated by a technique such as 3-D seismic imaging before wells are drilled in the new location.

The new rules also allow companies to disclose probable (2P) and possible (3P) reserves. Investors are already aware that there can be wide differences in these amounts, so it is not clear that this will have a material impact.