Top five things Canadian issuers need to know about the SEC’s new oil and gas reporting requirements

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As one of its last acts of 2008, the U.S. Securities and Exchange Commission (the SEC) issued its final rule adopting revisions to the oil and gas reporting disclosure requirements applicable to all U.S. domestic and most foreign issuers (the Final Rule). The rule revisions will become effective on January 1, 2010, and issuers will be required to begin complying with them in registration statements filed on or after that date, and in annual reports on Form 10-K and Form 20-F for fiscal years ending on or after December 31, 2009. Citing the potential for incomparable disclosures, the SEC will not permit issuers to follow the new rules prior to their effective date.

The new disclosure requirements will not apply to Canadian foreign private issuers that file their annual reports on Form 40-F under the Multi-Jurisdictional Disclosure System (MJDS) and comply with Canadian disclosure requirements under National Instrument 51-101 - Standards for Oil and Gas Activities (NI 51-101), but will apply to Canadian foreign private issuers who have obtained exemptions in Canada permitting them to estimate reserves and disclose related oil and gas activities in accordance with SEC requirements.

The Final Rule should ultimately result in greater similarity between, and in turn comparability of, the public disclosure of U.S. and Canadian oil and gas issuers. The following summarizes the top five things Canadian issuers need to know about the new rules.

1 Move toward PRMS classifications and COGEH definitions

As the Final Rule represents the first significant revisions in U.S. oil and gas disclosure requirements in over 25 years, it is no surprise that the definitions in the old rules required updating to reflect changes in the oil and gas industry and markets and the development of new technologies. Many of the new and revised definitions in the Final Rule were drafted to be consistent with the Petroleum Resources Management System (PRMS) which is the classification system for petroleum reserves and resources approved by the Society of Petroleum Engineers. Definitions for the terms “deterministic estimate”, “probabilistic estimate” and “resources” in the Final Rule were based on the Canadian Oil and Gas Evaluation Handbook (COGEH).

The adoption of PRMS and COGEH terminology in the Final Rule will make U.S. disclosure more consistent with NI 51-101 as the definitions in NI 51-101 are also based on PRMS and COGEH terminology.
2 12-Month Average Pricing

The Final Rule requires issuers to report oil and gas reserves using 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, unless prices are defined by contractual arrangements, excluding escalations based upon future conditions. This is different than the NI 51-101 approach which requires issuers to value their reserves on future prices and costs that are based on either contractual prices and costs, if applicable, or a reasonable outlook of the future.

The SEC's intent behind the new pricing requirement in the Final Rule is to increase comparability between different issuers' reserves disclosures while mitigating the variability that the current single-day, fiscal year-end spot price may have on reserves estimates.

Most Canadian commenters supported the use of a 12-month average price to serve as a proxy for economic conditions that determine the economic producibility of reserves. Certain commenters, including several Canadian issuers, noted that the use of an average price would reduce the effects of short term volatility and seasonality, while maintaining comparability of disclosures among issuers. Six commenters, five being Canadian issuers, recommended the use of a 12-month daily average price because they thought that a daily average price would be more appropriate than a monthly average price and noted that oil sales contracts are often based on daily averages; however, the SEC chose not to accept that recommendation.

3 Extraction of bitumen and other unconventional resources

The Final Rule revises the definition of “oil and gas producing activities” to include extraction of saleable hydrocarbons from certain “unconventional” and “non-traditional” sources such as bitumen extracted from oil sands and oil and gas extracted from coal and shales. The intent of this amendment is to shift the focus of the definition to the final product of such activities, regardless of the extraction technology used. All commenters on this issue supported the inclusion of extraction of unconventional resources as, “oil and gas producing activities”, as is already the case under NI 51-101.

In similar fashion to the NI 51-101 disclosure requirements, the Final Rule requires the separation of reserves based on final product, distinguishing between final products that are traditional oil or gas and final products of synthetic oil or gas. The SEC believes this separation will allow investors to identify resources in projects producing synthetic oil or gas that may be more sensitive to economic conditions than other resources. One Canadian commenter was concerned that distinguishing bitumen or other intermediate synthetic product from traditional oil and gas creates a false and misleading sense of comparability when, in reality, producers that upgrade bitumen and sell synthetic crude do not face the same risks and rewards as do producers that sell the bitumen itself. Though the SEC considered this comment, it believes that the distinction between an issuer's traditional and unconventional activities is an important one from an investor's perspective because many of the unconventional activities are costlier and, therefore, have a much higher threshold of economic producibility.

4 Optional disclosure of unproved reserves

In Canada, under NI 51-101, disclosure of probable reserves is mandatory and disclosure of possible reserves is voluntary; however, in the U.S. under the Final Rule, disclosure of both probable and possible reserves will be voluntary. The Final Rule adopts definitions of the terms “probable reserves” and “possible reserves” that are consistent with the PRMS. If an issuer chooses to disclose such reserves under the Final Rule, it must provide the same level of geographic detail as required for proved reserves and must state whether the reserves are developed or undeveloped. Issuers making such disclosure must also disclose the relative uncertainty associated with these classifications of reserves estimations.

The SEC’s intent behind this change is to enable issuers to provide investors with more insight into the potential reserves base that management of such issuers may use as the basis for their decisions to invest in resource development.

Most commenters, including two Canadian issuers that commented on this issue, supported permitting the disclosure of probable and possible reserves in filed documents. However, several commenters, including one Canadian commenter, cautioned that there could be significant variability among disclosures. Some commenters pointed to the broad range of technologies and methods used by issuers to support these estimates as a factor that would lead to inconsistent disclosure and also noted that, in some cases, such disclosure could confuse
investors and expose issuers to increased litigation because of the inherent uncertainty associated with probable and possible reserves. After noting that numerous oil and gas issuers already disclose unproved reserves on their web sites and in press releases, and that such disclosure does not appear to have created confusion in the marketplace, the SEC decided to make these disclosures voluntary, and to allow each issuer to exercise its own discretion in that regard in its SEC filings.

5 Preparation of reserves estimates and third party reports
The Final Rule does not require that an independent third party prepare, or conduct a reserves audit of, the issuer’s reserves estimates. It does, however, require issuers to provide a general discussion of the internal controls that are used to assure objectivity in the reserves estimation process as well as to disclose the qualifications of the technical person primarily responsible for preparing the reserves estimates or conducting the reserves audit (if an issuer discloses that such a reserves audit has been performed) regardless of whether the technical person is an employee or an outside third party. This is unlike NI 51-101, which, absent an exemption, mandates that a third party report be prepared and disclosed.

If an issuer represents that a third party prepared the reserves estimates or conducted a reserves audit of the reserves estimates, the issuer must file a report of the third party as an exhibit to the relevant registration statement or report. These third party reports need not be the full “reserves report.” Rather, they could be shorter reports that summarize the scope of work performed by, and conclusions of, the third party.

Conclusion
The Final Rule represents a welcome update of the U.S. oil and gas reporting disclosure requirements and brings such requirements closer to applicable Canadian rules. While there are some continuing differences, comparisons between the public disclosure of U.S. and Canadian oil and gas issuers should soon be easier.

For further information, please contact your Stikeman Elliott representative, any of the authors listed above or any member of our Corporate Finance and Securities Group listed at www.stikeman.com


2] A Canadian issuer qualifies as a foreign private issuer so long either: (1) no more than 50% of the issuer’s outstanding voting securities are held by U.S. residents; or (2) none of the following is true: (i) a majority of the executive officers or directors are U.S. citizens or residents; (ii) 50% or more of the assets of the issuer are located in the United States; or (iii) the business of the issuer is administered principally in the United States. Issuers must test their eligibility as foreign private issuers as at the end of their second fiscal quarter. A Canadian foreign private issuer will be eligible to use MJDS so long as: (1) it has been subject to the periodic reporting requirements in Canada for a period of at least 12-calendar months immediately preceding the filing of the relevant MJDS Form and is currently in compliance with such obligations; and (2) the aggregate market value of the public float of the issuer’s outstanding equity securities is US$75 million or more. Canadian foreign private issuers wishing to use Form 40-F to file their annual report must test their eligibility to use Form 40-F as of the end of the fiscal year to which the report relates.

3] The commentary referenced herein is the commentary that was submitted to the SEC during the public consultation period preceding the release of the Final Rule.