THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

July 1, 2004

The Honorable John D. Dingell
Ranking Member
Committee on Energy and Commerce
U.S. House of Representatives
Washington, D.C. 20515-6115

Dear Congressman Dingell:

In your letter of May 4th, you explained that you are examining the implementation of the accounting practices requirements of the Energy Policy and Conservation Act of 1975 and the facts and circumstances surrounding a number of recent high-profile announcements by oil companies and natural gas producers that they had overstated their oil and gas reserves. You asked me to provide you with information that would assist you in your examination of this matter.

I have asked Donald Nicolaisen, the SEC's Chief Accountant, and Alan Beller, the Director of the Division of Corporation Finance, to provide you with the information you have requested. Their memorandum is enclosed.

If you have any questions on this information please do not hesitate to contact me or to have your staff contact Mr. Nicolaisen at (202) 942-4400 or Mr. Beller at (202) 942-2929.

Sincerely,

William H. Donaldson

Enclosure

cc: The Honorable Joe Barton
The Honorable Cliff Stearns
The Honorable Jan Schakowsky
The Honorable Ralph Hall
The Honorable Rick Boucher
The Honorable Spencer Abraham
The Honorable Patrick Henry Wood III
Mr. Robert H. Herz

MEMORANDUM

June 24, 2004

To : Chairman Donaldson

From : Alan Beller, Director, Division of Corporation Finance
Donald Nicolaisen, Chief Accountant

Re : Response to Congressman Dingell's May 4, 2004 letter

You have asked us to respond to the eight questions asked by Congressman Dingell in his May 4th letter to you. We have provided a response to each question below.

Question 1

The accounting practices provisions of the Energy Policy and Conservation Act of 1975 (42 U.S.C. Sec. 6383) required the Securities and Exchange Commission (SEC) to develop within two years accounting practices to be followed in the preparation of accounts by persons engaged, in whole or in part, in the production of crude oil or natural gas in the United States. It required the SEC to consult with the Secretary of Energy (DOE), the Federal Energy Regulatory Commission (FERC), and the General Accounting Office (GAO) in developing such practices, and authorized the SEC to defer to FASB pronouncements, under certain circumstances. It also spelled out general requirements for these accounting practices.

Please discuss and explain the steps that have been taken to implement, administer, and enforce this mandate.

Response

Since the Energy Policy and Conservation Act of 1975, the FASB has issued three statements in this area, Statement 19 (December 1977), Statement 25 (February 1979) and Statement 69 (November 1982). Also, since 1975, the SEC has had several initiatives regarding the accounting practices by companies engaged in the production of crude oil or natural gas. Among these initiatives are the following:

- **Accounting Series Release 253 (8/31/78)**
  ASR 253 permits the use of either the successful efforts method or the full cost method of accounting. In addition, in ASR 253, the SEC provided interpretive guidance on
  - standards for the successful efforts method of accounting, and
  - rules that require audited disclosure of certain supplemental financial and operating data, including information on future net revenues from

production of proved oil and gas reserves, that apply regardless of the accounting method followed.

In addition, in ASR 253, the SEC announced a decision to pursue the development of reserve recognition accounting (RRA) in the oil and gas industry, which ideally would replace both of the methods of accounting that ASR 253 permitted.

- **Accounting Series Release 257 (12/19/78)**
  In ASR 257, the SEC provided interpretive guidance on various rules to conform to FASB Statement 19. In addition, in ASR 257, the SEC revised certain definitions, such as proved oil and gas reserves, to conform to those the Department of Energy adopted for its financial reporting system.

- **Accounting Series Release 258 (12/19/78)**
  In ASR 258, the SEC adopted uniform rules to be followed by companies applying the full cost accounting method.

- **Accounting Series Release 269 (9/24/79)**
  In ASR 269, the SEC adopted rules which would require oil and gas producers to present an audited supplemental summary of oil and gas producing activities prepared on the basis of RRA.

- **Accounting Series Release 270 (9/24/79)**
  In ASR 270, the SEC delayed implementation of the requirement to audit the reserve disclosures called for under ASR 253 and the supplemental RRA summary required under ASR 269 until fiscal years beginning after December 26, 1980.

- **Accounting Series Release 277 (4/17/80)**
  In ASR 277, the SEC announced that the requirement to present an audited supplemental RRA summary would be postponed until a decision was reached as to whether to adopt reserve recognition accounting as a uniform method of accounting in the primary financial statements.

- **Accounting Series Release 289 (2/26/81)**
  In ASR 289, the SEC announced that after extensive consideration it no longer considered reserve recognition accounting to be a viable method of accounting for oil and gas producers because of the inherent uncertainty of recoverable reserve estimates. The SEC also announced its support for a Financial Accounting Standards Board initiative to develop a comprehensive package of disclosures, including future net revenues from proved oil and gas reserves, for presentation outside of the primary financial statements of oil and gas producers. This initiative culminated in FASB Statement 69.

- **Financial Reporting Release 9 (12/15/82)**
  In FRR 9, the SEC required oil and gas producers to comply with the provisions of FASB Statement 69 concerning supplemental disclosures by oil and gas producers.

Question 2

Please discuss and explain the key requirements of Statement of Financial Accounting Standards Nos. 19 (Financial Accounting and Reporting by Oil and Gas Producing Companies), 25 (Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies), and 69 (Disclosure about Oil and Gas Producing Activities).

Please explain the difference between "successful efforts," "full cost," and "value" accounting. Which method has been mandated for SEC registrants and why? What impact has that determination had on transparency and accuracy of accounting and disclosures? Is this issue being revisited in light of the recent scandals?

Response

We have briefly summarized the FASB standards relating to financial reporting by oil and gas producing companies for you as follows.

- **FASB Statement 19, Financial Accounting and Reporting by Oil and Gas Producing Companies (December 1977)**
  Pursuant to Statement 19, oil and gas producing companies are required to use a specific form of successful efforts accounting. Under successful efforts accounting, as described below, only certain costs are capitalized based on the nature of the costs, and the resulting success in discovering proved reserves. In addition, pursuant to Statement 19, companies are required to provide disclosure regarding reserve quantities, incurred costs, and capitalized costs.

- **FASB Statement 25, Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies (February 1979)**
  Statement 25 suspended the Statement 19 effective date for mandatory adoption of the successful efforts method. With this statement, the FASB responded to the SEC's guidance in ASR 253, which left in place both successful efforts and full cost accounting while the SEC evaluated the development of reserve recognition accounting. The FASB retained the Statement 19 requirements for disclosure of reserves, incurred costs, and capitalized costs, although it permitted the required disclosure of reserve quantities to be made outside the financial statements with a revised effective date.

- **FASB Statement 69, Disclosures about Oil and Gas Producing Activities (November 1982)**
  In Statement 69, the FASB established a comprehensive set of disclosure requirements for oil and gas producing activities by publicly traded entities. Statement 69 replaced the requirements of several earlier statements, including Statements 19 and 25.

  Pursuant to Statement 69, all oil and gas producers must provide the following disclosure on a country-by-country basis, in an unaudited note to the financial statements:
  - estimated proved oil and gas reserve quantities, including changes to previous estimates;
  - capitalized costs relating to oil and gas producing activities;
  - costs incurred in property acquisition, exploration, and development activities;
  - results of operations for oil and gas producing activities; and
  - a standardized measure of discounted future cash flows relating to proved oil and gas reserves.

We provide a brief explanation of each of the alternative methods of accounting for oil and gas producing activities below.

- **Full Cost**
  Pursuant to the Full Cost accounting method, a company is required to capitalize, subject to a so-called "ceiling limitation" described below, all costs incurred in searching for oil and gas reserves regardless of whether the incurred costs result in the discovery of proved reserves. Under the Full Cost accounting method, a company must accumulate capitalized costs in country-specific cost centers, subject to the ceiling limitation in each cost center, and amortize the costs as charges to income as reserves are produced and generate revenues and income. The calculation of a ceiling limitation, which is based on current prices of proved oil and gas reserves, is required to ensure that costs capitalized under this method do not exceed revenues to be recognized from proved reserves.

- **Successful Efforts**
  Under Successful Efforts accounting, costs are attributed to specific properties or aggregations of properties. Acquisition costs, exploratory costs in respect of proved reserves and development costs are capitalized. As a result, costs are capitalized only for properties with proved reserves. Other costs are expensed when incurred. Capitalized costs relating to producing properties are subsequently amortized over the life of the producing property. However, there are instances where a company would be required to write-off capitalized costs. For example, a company would write off previously capitalized costs when it does not classify the reserves as proved within a year

of incurring the costs. In addition, both the properties and capitalized costs are subject to impairment testing.

- **Value Accounting**
  Value accounting is not a generally accepted accounting method. At the time the FASB was deliberating the issues that ultimately resulted in the issuance of Statement 19, there was discussion of the discovery value and current value accounting methods. Under the discovery value method, as generally discussed in the deliberations of Statement 19, reserves would be recorded as assets at their estimated value when the reserves are discovered or developed. The resulting asset would not be adjusted for changes in price, but would be adjusted for revisions in estimated reserve quantities. Under the current value method, as generally discussed in the deliberations of Statement 19, reserves would be recorded at their estimated value when the reserves are discovered or developed. The resulting mineral reserve asset *would be adjusted* for changes in price, as well as for revisions in estimated reserve quantities. The FASB ultimately rejected value accounting because of "problems in measuring the value of reserves with reasonable accuracy at the point of discovery." We refer you to Appendix B, Basis for Conclusions, of Statement 19 for a full discussion of the accounting alternatives the FASB considered and reasons for rejecting value accounting.

Whether they follow Successful Efforts or Full Cost accounting, all oil and gas producers must provide the "disclosure required by FASB Statement 69.

Following the enactment of the Energy Policy and Conservation Act of 1975, and as required by that Act, the SEC considered the appropriate method of accounting. In 1978, the SEC concluded that both historical cost methods (Full Cost and Successful Efforts) were inherently limited but that it would be appropriate to leave both methods in place while a project was undertaken to develop a value-based accounting method referred to as RRA, which was at the time thought to be a superior method. In 1981, the SEC decided after considerable study that RRA was not a viable method of accounting because of the inherent uncertainty of recoverable reserve estimates. The two historical cost methods thus remained in place. In 1986, the SEC considered a staff recommendation to eliminate the Full Cost method, but ultimately decided to continue to allow both methods.

Question 3

In 1979, FAS 25 adopted the definitions of "proved oil and gas reserves," "proved developed oil and gas reserves," and "proved undeveloped oil and gas reserves" as established by the Department of Energy for its Financial Reporting System and adopted by the SEC in 1978 in ASR No. 257. Proved oil and gas reserves are defined as "the estimated quantities of crude oil, natural gas, and natural gas liquids which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions, i.e.,

prices and costs as of the date the estimate is made." The key determination is "reasonable certainty."

Please identify and explain any SEC or FASB guidance relevant to assessing "reasonable certainty." Is this guidance adequate? Is it being reviewed in light of the recent debacles? If not, why not?

Response

As noted above with respect to ASR 257, in 1978 the SEC revised its definition of proved oil and gas reserves to conform to that of the Department of Energy. While the Department of Energy's definition included the concept of reasonable certainty, to our knowledge, it never defined that concept. Just as the SEC used the Department of Energy definition of proved reserves, the FASB, in Appendix B of FASB Statement 25, defined proved reserves by referencing ASR 257.

The SEC staff continually provides guidance to individual companies through its review and comment process. The SEC staff also periodically provides guidance to a broader audience in the form of current issues outlines, telephone interpretations, and other means, usually via the SEC website. The SEC staff refines that guidance to reflect the issues the SEC staff identifies and the SEC staff is committed to continuing that process in the future. In November 2000, the Division of Corporation Finance provided written guidance regarding reasonable certainty. The guidance is included in its entirety in Section VIII.A.16 of the Current Issues and Rulemaking Projects outline at http://www.sec.gov.

Reasonable certainty implies that proved reserves have a higher likelihood of recovery than not. In our guidance, we explain that reasonable certainty is determined by supporting geological and engineering data that indicates its assumptions such as decline rates, recovery factors, reservoir limits, recovery mechanisms and volumetric estimates, gas-oil ratios or liquid yield are valid. If the area in question is new to exploration and there is little supporting data for decline rates, recovery factors, reservoir drive mechanisms, etc., a conservative approach is appropriate until there is enough supporting data to justify the use of more liberal parameters for estimating proved reserves. The concept of reasonable certainty implies that, as more data becomes available, a positive, or upward, revision to proved reserves is much more likely than a negative, or downward, revision.

While the SEC staff has, from time to time, considered whether the definitions should be revised, we have not identified ways to significantly improve them. We believe these definitions are sufficiently understood to enable reasonably consistent disclosures by oil and gas companies.

Question 4

What is the relevance and importance of oil and gas reserve disclosures to investors? To national energy policy decisions and national economic planning? What would be the impact of significant misrepresentations of such reserves? What steps are you taking to restore credibility and reliability in this area?

Response

Oil and gas reserves are often the most material assets of petroleum exploration and production companies. Because of the inherent difficulty of accurately estimating them, the reserve volumes are not included as assets in the audited balance sheets. As a result, the SEC and the FASB require these companies to provide a significant amount of supplemental information relating to reserves.

From a financial reporting perspective, the oil and gas reserve disclosures presented by public companies to comply with generally accepted accounting principles and SEC requirements are intended to provide investors, creditors, and other potential and current financial statement users with relevant information. In announcing an amendment to our rules to conform to the then new disclosure requirements of FASB Statement 69, the Commission, in Financial Reporting Release 9, expressed its view that the supplemental disclosures about oil and gas reserves provide meaningful and useful information in assessing future cash flows – which represents a primary objective of financial reporting.

As to the reliability of oil and gas reserve information, questions concerning the inherent uncertainty of estimating recoverable reserves have existed since the SEC initiated its experiment with reserve recognition accounting in 1978. The lack of reliable reserve estimates was the key factor in the Commission's 1981 decision to abandon reserve recognition accounting as a potential method of accounting in the primary financial statements of oil and gas producers.

The FASB's adoption of supplemental oil and gas reserve disclosures based on certain of the same reserve estimates was an effort to balance the relevance of information about proved oil and gas reserves with the limitation in reliability caused by uncertainties inherent in the reserve estimating process. The supplemental information is presented in an unaudited footnote to the financial statements.

Significant misrepresentations of proved reserves could adversely impact investor confidence in the accuracy and reliability of the reserve data disclosed by industry participants. The Division of Corporation Finance reviews the disclosure of many companies for compliance with disclosure rules. When the Division selects a company with material operations in the oil and gas industry for review, it also reviews the company's relevant petroleum engineering reserve reports. As appropriate, the Division will request revised or additional disclosure. As noted in our response to Question 3, because estimating reserve amounts is difficult, the concept of reasonable certainty was introduced so that adjustments would generally be upward.

Question 5

Press reports indicate that the SEC is conducting a formal investigation into widespread overbooking and subsequent write-down and restatement of oil and natural gas reserves by the Royal Dutch/Shell Group.

In the wake of this debacle, is the SEC examining practices and disclosures across the industry? If not, why not? If so, please explain the scope of that inquiry.

Is the SEC investigating announced reserve write-downs and restatements by any other companies? If so, please identify each company, the percentage/amount of overstatement and/or subsequent write-down, the estimated restatement and its financial impact, if known, and the outside auditor in each case.

Response

As a matter of public policy, the SEC does not comment on the existence of any specific inquiry or investigation.

Question 6

Was the SEC or its staff aware of these problems beforehand or did they come as a surprise? Did Wall Street analysts raise any concerns about the oil and gas reserve accounting and disclosures prior to Shell's revelations earlier this year?

For the period covering the past ten years, how many SEC staff were assigned to review these filings and what has been their background and training? What level of review has been given to oil and gas filings, especially the disclosures of reserve quantities in the financial statements?

Response

As noted above, we are unable to respond to these questions involving specific entities. As a matter of public policy, the SEC does not comment on the existence of any specific inquiry or investigation.

In addition, also as a matter of public policy, the SEC does not publicly disclose whether a company has been subject to staff review. However, the Division of Corporation Finance selectively reviews the filings of public companies and, as you know, the Division is now required to review all public companies at least once every three years. In the last three years, the Division has reviewed filings of over 150 companies with industry codes indicative of companies with oil and gas reserves.

The Division undertakes different levels of reviews of filings. A filing may be subject to a full, cover-to-cover review in which all disclosure in the filing is reviewed, a financial

statement review in which the financial statements and related disclosure, including the management's discussion and analysis, is reviewed, or a limited scope review, or a targeted issue review, in which certain aspects of a company's disclosure are targeted for review. The level of review assigned to a filing is often the result of our evaluation of a company's disclosure as it relates to certain criteria.

When a company with oil or gas reserves is selected for a full, cover-to-cover review by the Division's legal and accounting staff, one of the Division of Corporation Finance's two petroleum engineers reviews the estimated proved reserves and will generally request that the company provide us with supplemental support for those estimates. This support might include reserve reports, drilling logs and production histories, among other things. If, upon reviewing this data, the Division engineer determines that the data may not support the level of proved reserves claimed, the Division may, through the comment process, suggest that the company revise its estimate downward. In addition, the Division's petroleum engineers undertake targeted issue reviews in which they will evaluate the reserve disclosure by an oil and gas company.

Question 7

In a recent Leader entitled "Needlessly murky," The Economist (April 10, 2004 at 12) sharply criticized U.S. accounting rules on how oil and gas companies book reserves. "The boldest reform required now is for the SEC to demand that all energy firms whose shares are traded in America have their reserves reviewed by independent auditors. Ironically, oil firms from Russia, India and China have already done this to bolster their credibility."

What is the rationale of the SEC and the FASB for not having adopted this requirement. Is this under reconsideration in light of the recent debacles? If not, why not?

Response

The SEC does not currently require "independent auditors" to review the reserves of energy companies. While certified public accountants are trained to perform audits of financial statements in accordance with generally accepted auditing standards, they would not necessarily have the expertise necessary to provide an opinion as to the accuracy of oil and gas reserves. Nevertheless, as part of their audit of the financial statements, they are required to perform certain limited procedures related to the disclosures required by FASB Statement 69 (see Auditing Standards section 9558 Required Supplementary Information, Codification of Statements on Auditing Standards No, 52, Auditing Interpretation No. 1). In view of the recent revisions of many companies in this industry, the internal controls over preparation of reserve estimates may have been inadequate. A recently approved auditing standard by the PCAOB requires auditors to evaluate and report on controls. Further, we will review these concerns with the PCAOB and evaluate, with them, whether auditors should be required to perform additional work.

The Society of Petroleum Engineers has prepared "Standards Pertaining to the Estimating and Auditing of Oil and Gas Reserve Information" that are applicable to petroleum engineers. However, the standards are not binding on SPE members and the SPE does not have any oversight or enforcement mechanisms. In addition, while some states issue professional licenses to engineers and geologists, not all of these states have ongoing requirements to maintain registration or certification status.

Question 8

The report of the law firm Davis Polk & Wardell to the Shell Group audit committee found that "the booking of 'aggressive' reserves and their continued place on Shell's books were only possible because of certain deficiencies in that company's controls. For example, the internal reserves audit function was both understaffed and undertrained." It also found that Shell's internal guidelines "were not adequately designed to yield compliant reporting of proved reserves."

What internal and external checks are required regarding internal controls? What is the responsibility of management for establishing and maintaining an adequate internal control structure and procedure for financial reporting? What is the responsibility of auditors for flagging problems in internal controls? Why did they miss the current crop of problems?

Response

The securities laws impose certain responsibilities on managements of public companies for establishing and maintaining an adequate internal control structure and procedures for financial reporting. Pursuant to Section 13(b)(2)(A) of the Exchange Act of 1934, public companies are required to make and keep books, records, and accounts, which in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer. Section 13(b)(2)(B) of that same Act requires public companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that, among other things, transactions are recorded as necessary (i) to permit preparation of financial statements in conformity with generally accepted accounting principles or other criteria applicable to such statements, and (ii) to maintain accountability for assets.

As a result of the Sarbanes-Oxley Act of 2002, financial officers of public companies now must certify that they are responsible for establishing, maintaining, and regularly evaluating the effectiveness of the issuer's internal controls, making certain disclosures to the issuer's auditors and audit committee of the board of directors about the issuer's internal controls, and including information in the issuer's quarterly and annual reports about the evaluation and whether there have been significant changes in the issuer's internal controls or other factors that could significantly effect internal controls subsequent to the evaluation. In addition, as a consequence of the Sarbanes-Oxley Act, managements of public companies will soon be required to assess and report on the effectiveness of the company's internal controls over financial reporting as of the end of

the company's most recent fiscal year. Similar requirements apply to public companies and their chief executive and financial officers in respect of disclosure controls and procedures.

Despite the fact that supplemental oil and gas disclosures are presented in an unaudited note to the financial statements, an auditor still has certain professional responsibilities associated with these disclosures. The auditor is responsible for obtaining an understanding of internal controls sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and determining whether they have been in operation. In addition, the auditor soon will be required, under the provisions of the Sarbanes-Oxley Act, to attest to and report on management's assessment of the effectiveness of internal controls.

On the specific issue of auditor association with supplementary oil and gas disclosures, an Auditing Interpretation of AU section 558, Required Supplementary Information indicates that the auditor should consider its provisions with respect to disclosures by publicly traded entities that have significant oil and gas producing activities. This interpretation provides a list of procedures the auditor should apply to the information. For example, the auditor should compare the entity's recent production with its reserve estimates for properties that have significant production or significant reserve quantities and inquire about disproportionate ratios.

In March 2004, the PCAOB adopted Auditing Standard No.2, *An Audit of Internal Control Over Financial Reporting Performed in Connection with an Audit of Financial Statements.* The standard establishes requirements and provides directions that apply when an auditor is engaged to audit both a company's financial statements and management's assessment of the effectiveness over internal control over financial reporting. The SEC approved PCAOB Standard No. 2 on June 17th.