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February 5, 2008

VIA EMAIL

Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: File No. S7-29-07

Dear Ms. Morris:

We write on behalf of our client, Sir Philip Watts, to comment on the U.S. Securities and Exchange Commission ("SEC") Concept Release on Possible Revisions to the Disclosure Requirements Relating to Oil and Gas Reserves published in the Federal Register on December 18, 2007. Sir Philip is the former Chairman of Royal Dutch/Shell Transport's ("Shell") Committee of Managing Directors.

In February 2004, Shell recategorized approximately 20% of its proved oil and gas reserves base. In August 2004, Shell entered into a no-admission no-denial settlement with the SEC and the UK Financial Services Authority ("FSA") regarding allegations that it had fraudulently overstated its proved reserves in violation of SEC Rule 4-10 (17 CFR § 210.4-10). In November 2005, following an extensive investigation, the FSA notified Sir Philip that it had discontinued its investigation and would take no action against him. At the end of August 2006, the SEC notified Sir Philip that it had also decided to terminate its investigation without enforcement action against him.

As part of a related securities class action and during the course of the SEC's investigation, Sir Philip subpoenaed documents from the SEC's Division of Corporation Finance ("CorpFin") regarding the Staff's interpretations of Rule 4-10 and communications with oil and gas companies about the rule. On August 1, 2006, we sent to the SEC the enclosed letter, which discussed the documents obtained through the subpoena process and demonstrated that the CorpFin Staff had, through a Staff Outline,[1] speeches, and letters, created its own definition of proved oil and gas reserves that differed from the oil and gas industry's understanding of the requirements of Rule 4-10. The letter noted that the subpoenaed documents reflect that oil and

[1] "Staff Outline" refers to the following documents posted on the SEC website, www.sec.gov: (1) *Division of Corporation Finance: Current Accounting and Disclosure Issues* (June 30, 2000); (2) *Current Issues and Rulemaking Projects* (Nov. 14, 2000); and (3) *Division of Corporation Finance: Frequently Requested Accounting and Financial Reporting Interpretations and Guidance* (Mar. 31, 2001), and any subsequent amendments or versions of these documents.

gas companies applied Rule 4-10 inconsistently with one another and that the CorpFin staff also inconsistently applied the requirements of Rule 4-10.

The Staff Outline's section dealing with Rule 4-10's proved reserves definition began with this paragraph:

> Over the last several years, the estimation and classification of petroleum reserves has been impacted by the development of new technologies such as 3-D seismic interpretation and reservoir simulation. Computer processor improvements have allowed the increased use of probabilistic methods in proved reserve assessments. These have led to issues of consistency and, therefore, some confusion in the reporting of proved oil and gas reserves by public issuers in their filings with the Commission. This section discusses some issues the Division of Corporation Finance's engineering staff has identified in its review of such filings.

The Staff Outline did not clear up the "confusion" occasioned by Rule 4-10's failure to keep up with technological developments in the industry but, instead, increased it. A letter from ExxonMobil responding to a CorpFin Staff letter noted the effect of the SEC staff's communications with industry members:

> As we have noted in the past, we believe that a number of the issues raised in the course of our correspondence are best addressed on an industry wide basis. We remain concerned that, in certain instances, interpretative guidance provided by the SEC staff from time to time can be viewed as effectively amending Regulation S-X without the benefit of the formal rulemaking process, which necessarily involves soliciting input from key parties including industry. We reiterate our support for the establishment of a joint government/industry technical group as the most effective means to chart a path forward for the benefit of all interested parties and to help ensure transparency in the rule making process.[2]

Cambridge Energy Research Associates ("CERA") published a study in February 2005, a year after Shell's recategorization announcement. The study stated that the SEC "appears to have shifted from 'reasonable certainty' [, the standard set forth in Rule 4-10 on reporting proved oil and gas reserves,] further toward [a standard of] 'absolute certainty' and, in so doing, has transformed a principle-based reporting system to a rule-based one, without the kind of transparency and discussion that the SEC utilizes for other kinds of rule making."[3] In discussing the Staff Outline, CERA noted:

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[2] Letter from Donald D. Humphreys, Vice President and Controller, ExxonMobil Corp. to H. Roger Schwall, Assistant Director, SEC at 3-4 (July 10, 2003)

[3] Cambridge Energy Research Associates, In Search of Reasonable Certainty: Oil and Gas Reserves Disclosure at 15 (Feb. 2005). The CERA report was sponsored by over thirty professional organizations: Accenture; Akin, Gump, Stauss, Hauer & Feld; Amerada Hess; Anadarko Petroleum; Apache; BDO Seidman; BP; Bracewell & Patterson;

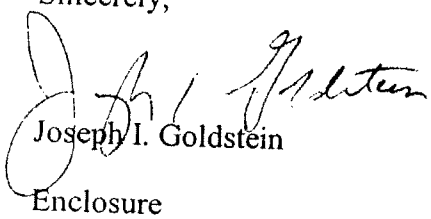
(cont'd)

> Both companies and the SEC began to treat the outcome of their clarification discussions as if they were rules—provided that a company consistently applied the agreed approach, this would support a presumption that their reserves met the test of 'reasonable certainty' in a move toward a more mechanical approach to compliance. However, these new 'rules' did not benefit from prior consultation with the industry at large and applied to particular situations. This increased the likelihood that they would not be sufficiently broad to cover a wider range of situations.[4]

We believe that it is appropriate for the SEC to address Rule 4-10 through the formal rulemaking process pursuant to the Administrative Procedures Act. This will enable the SEC to craft a rule that benefits from and incorporates the advice of experts in the oil and gas industry who have developed petroleum fields throughout the world, often in remote areas, using modern methods and cutting-edge technology.

Please accept the enclosed document as Sir Philip's comment letter illustrating the urgent need for the SEC to revisit Rule 4-10 and provide the oil and gas industry with a common understanding of what, precisely, is meant by "proved" oil and gas reserves.

Sincerely,



Joseph I. Goldstein

Enclosure

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ChevronTexaco; ConocoPhillips; DeGolyer & MacNaughton; Deloitte & Touche; Devon Energy; El Paso Production; Eni; ExxonMobil; Goldman Sachs; Kerr-McGee Oil & Gas; KPMG; LaRoche Petroleum Consultants; Marathon Oil Company; Netherland, Sewell & Associates: Occidental Petroleum; Pioneer Natural Resources; PricewaterhouseCoopers; Ryder Scott; Shearman & Sterling; TNK-BP; Total; RPS Energy; Vinson & Elkins; and Wintershall. *Id.*, at ii.

[4] *Id.*, at 22-23.

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August 1, 2006

VIA E-MAIL AND OVERNIGHT MAIL

David L. Peavler, Esq.
Assistant District Administrator
Office of Enforcement
Fort Worth District Office
U.S. Securities and Exchange Commission
Burnett Plaza, Suite 1900
801 Cherry Street
Fort Worth, TX 76102-6882

Re: In the Matter of Royal Dutch Petroleum Company (FW-02742)

Dear Mr. Peavler:

This letter supplements and replaces the April 28, 2006 letter regarding the proved reserves reporting process as illuminated by U.S. Securities and Exchange Commission ("SEC") comment letters and documents. The reason for this supplemental letter is that additional relevant documents have been recently produced to Watts by the SEC.

In connection with ongoing class action litigation, Watts subpoenaed the SEC for documents and testimony regarding communications between the SEC and Royal Dutch Shell, plc ("Shell"), and various third parties regarding Rule 4-10, Regulation S-X ("Rule 4-10"). The Office of the General Counsel began producing responsive documents on April 4. The initial production included only documents authored by Division of Corporation Finance ("CorpFin") Staff. On June 19, 2006, the Office of the General Counsel supplemented the SEC's production with additional letters authored by SEC Staff and added letters received from certain major oil and gas companies.

The documents produced to date demonstrate that the CorpFin Staff has, through the SEC Staff Outline,[1] speeches, and letters, created its own definition of proved oil and gas reserves in place

[1] As used herein, the "Staff Outline" refers to the following documents posted on the SEC website, www.sec.gov: (1) *Division of Corporation Finance: Current Accounting and Disclosure Issues* (June 30, 2000); (2) *Current Issues and Rulemaking Projects* (Nov. 14, 2000); and (3) *Division of Corporation Finance: Frequently Requested Accounting and Financial Reporting Interpretations and Guidance* (Mar. 31, 2001), and any subsequent amendments or versions of these documents.

of that found in Rule 4-10.[2] The documents also demonstrate that the issues that contributed to Shell's recategorization of proved reserves were common to major oil and gas industry registrants.

The CorpFin Staff's actions raise serious questions about the internal functions of the agency and its compliance with the Administrative Procedures Act. It is not surprising that the oil and gas industry questions whether it is appropriate that two SEC petroleum engineers should dictate the criteria to be followed by industry participants in a sector as technically challenging, dynamic, and critical to the U.S. and world economies.[3] Industry observers have noted that the major oil and gas companies have booked far fewer reserves in the past year than had been booked over the past five years.[4] This raises the question: are oil and gas companies finding fewer reserves or is this caused by the CorpFin Staff's enforcement of the restrictive definition of proved reserves in the Staff Outline?

I. Rule 4-10 Defines Proved Reserves

A. Definition of Proved Reserves

Watts' document subpoenas to the SEC, narrowed following discussions with the Office of the General Counsel,[5] sought documents from January 1, 1996 to the present. The produced

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[2] Commissioner Atkins' speech to the American Institute of Certified Public Accountants ("AICPA") on December 5, 2005 addressed the issue of enforcement actions based on staff interpretations. Commissioner Paul S. Atkins, Remarks Before the American Institute of Certified Public Accountants (Dec. 5, 2005), Exhibit 1. Commissioner Atkins stated that the SEC "should not foster a regulatory environment that relies on informal guidance as a basis for enforcement action." Commissioner Atkins also recognized that "Enforcement actions should not be built around staff pronouncements" and that this view "happens to be the law of the land."

[3] The CorpFin engineers "have an unusual status at the agency. Their authority is magnified because the agency's lawyers and accountants 'won't second-guess them,' a former SEC official said. 'They are big fish in a little pond.'" Michael Schroeder, *Tiny SEC Staff Monitors Data on Oil Reserves*, WALL ST. J. (Mar. 12, 2004), Exhibit 2.

[4] Unfortunately, most big Western oil firms are getting worse at exploration. . . . such companies had an average reserve-replacement ratio of 129% over the past five years—meaning that they found 29% more oil and gas than they pumped. . . . Strip out [additions due to takeovers and purchases] and last year's average reserve replacement falls to a meagre 87%: overall, reserves are shrinking. The number gets even bleaker if you are interested in new discoveries, as opposed to more efficient extraction from existing fields. Wood Mackenzie, a consultancy, estimates that the ratio then falls below 50% . . . Exxon argues that reserve-replacement ratios, as defined by America's Securities and Exchange Commission (SEC) are not the best measure of exploration success. . . . Richard Ward, of Cambridge Energy Research Associates (CERA), a consultancy, believes that the SEC's definitions not only give a distorted picture of how much oil firms have, but also deter investment by making some projects appear uneconomic. CERA recently suggested that the Society of Petroleum Engineers, an industry group, take over the job of drawing up reserve definitions from the SEC.

Business, *Improving their fieldcraft*, THE ECONOMIST, Exhibit 3, at 73 (Apr. 15, 2006).

[5] As an initial matter, while reserving his right to seek additional responsive documents, Watts agreed to limit his document subpoenas to responsive documents reflecting communications between the SEC and Shell; Shell's

(cont'd)

documents indicate that, following a period of little communication on proved reserves issues, CorpFin Staff sent a flurry of comment letters to oil and gas registrants in 2002, 2003, and 2004. The correspondence reveals that major oil and gas companies, like Shell, disagreed with the CorpFin Staff's interpretation and application of Rule 4-10.[6]

In the correspondence, H. Roger Schwall, Assistant Director, CorpFin, informed Shell in 2003 that, with respect to proved reserves reporting,

> The SEC has maintained its own set of proved reserves definitions because the definitions by the SPE, and other organizations, are not written for the sole objective of protection of U.S. investors. They are very generic, to be used at the discretion of the company and are described more as guidelines than as hard and fast rules that must always be adhered to.[7]

The Office of the General Counsel represents

> that the reference in [Mr. Schwall's] letter to the SEC's "own set of proved reserves definitions" is a reference to Rule 4-10 of Regulation S-X.[8]

In addition, the Office of the General Counsel confirms that

(... cont'd)

external auditors KPMG LLP and PwC LLP; ExxonMobil Corp. ("ExxonMobil"); BP p.l.c. ("BP"); Chevron Corp. ("Chevron"); ConocoPhillips Corp. ("ConocoPhillips"); Total S.A. ("Total"); El Paso Corp.; Petróleo Brasileiro S/A (Petrobras); Unocal Corp.; Repsol YPF, S.A.; Statoil ASA ("Statoil"); Norsk Hydro ASA ("Norsk Hydro"); Eni SpA ("Eni"); Lukoil Oil Co.; Society of Petroleum Engineers ("SPE"); Society of Petroleum Evaluation Engineers ("SPEE"); World Petroleum Congress; Ryder Scott & Co. ("Ryder Scott"); Gaffney, Cline and Associates; The Strickland Group; DeGolyer and MacNaughton; American Petroleum Institute; Cambridge Energy Research Associates ("CERA"); Deloitte & Touche LLP; Ernst & Young LLP; and Arthur Andersen LLP.

[6] In addition, the Office of the General Counsel represented that CorpFin "does not maintain telephone logs or notes of telephone conversations or meetings with third parties." Letter from Katherine Cody, Esq., Assistant General Counsel to Joseph I. Goldstein (Apr. 21, 2006), Exhibit 4. It is difficult to understand how CorpFin supervises communications with registrants or conducts business in the absence of such records. Accordingly, the Office of the General Counsel was asked to "inform us what method is used by CorpFin to track what SEC Staff say to registrants, auditors, advisors, consultants, and others during telephone conversations and meetings." Letter from Joseph I. Goldstein to Katherine Cody, Esq., Assistant General Counsel (Apr. 26, 2006), Exhibit 5. No response has been received to date.

[7] Letter from H. Roger Schwall, Assistant Director, to Tim Morrison, Group Controller, Shell (July 10, 2003), Exhibit 6, at SEC00193 (because the comment letters and responses are voluminous, we have only attached the first page and referenced pages of each letter produced by the SEC—we would be happy to provide complete copies if requested). Mr. Schwall also stated, "We really do not wish to get into a debate of industry positions, as it is well known that an SPE paper can generally be found on any issue and support of any position on that issue." *Id.*, at SEC00192.

[8] Cody Letter (Apr. 21, 2006), *supra* note 6.

> Comments by the staff do not set or establish the definitions of terms in Commission rules and regulations. *See* 17 C.F.R. 202.1(d) (staff statements "do not constitute an official expression of the [SEC's] views"). *See, e.g., SEC v. National Student Mktg Corp.*, 68 F.R.D. 157, 160 (D.D.C. 1975); *Pennzoil Co. v. DOE*, 680 F.2d 156, 161-62 (Temp. Emer. Ct. App. 1982). Rule 4-10 and SFAS 69 say what they say—staff statements and opinions do not change their terms.[9]

We agree.

B. There Should Not Be Secret Agency Law

Rule 4-10 defines proved reserves 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.[10]

Contrary to Mr. Schwall's assertion that there are "hard and fast rules that must always be adhered to," there is no definition of "reasonable certainty" in Rule 4-10, and no settled meaning for the term in the oil and gas producing industry.[11] This is because Rule 4-10 is a principle-based standard. The SEC did not freeze the oil and gas industry's practices in the 1978 environment. Instead, after notice and public comment, the Commission issued a rule that did not define "reasonable certainty" that could adapt to evolving technology and markets. The rule remained unchanged as the oil and gas industry underwent a striking transformation in terms of technological advances, world market demands, changing political regimes, and ever-increasing oil and gas consumption patterns in North America, Europe, and Asia.

C. Promulgation of the Staff Outline Violated Enabling Statute

The current petroleum engineers on CorpFin Staff, Messrs. Winfrey and Murphy, joined the SEC in 1998 or 1999. In 2000, CorpFin appears to have determined that Rule 4-10's "reasonable certainty" criteria as applied by the oil and gas industry was not conservative enough and attempted to create settled meaning by publishing the Staff Outline and requiring adherence to it without following the requirements of the APA. The CorpFin petroleum engineers told the 2000

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[9] *Id.* (alterations in original).

[10] Rule 4-10(a)(2), Regulation S-X, 17 C.F.R. § 210.4-10(a)(2).

[11] The SEC also has not "maintained its own set of proved reserves definitions" unless it consists of secret law in violation of the Administrative Procedures Act ("APA").

Society of Petroleum Engineers ("SPE") conference that the SEC required compliance with the Staff Outline.[12]

The promulgation of the Staff Outline was inappropriate for a document amending an SEC Rule. James Murphy, CorpFin Petroleum Engineer, sent an email to Ronald Harrell, then the Chief Executive Officer of Ryder Scott, a petroleum engineering consultancy:

> Ron:
>
> Our interpretive position on the oil and gas definitions are finally posted to our website. To get there type the following URL address:
>
> sec.gov/offices/corpfin/acctdisc.htm
>
> Scroll down to issues in the Extractive industry and then down a little further Definition of Proved Reserves.
>
> Since this is not really a change in the rulemaking we are not formally requesting public comments. However, any informal feedback you would like to offer will be appreciated and considered.
>
> Also, feel free to pass this along to anyone in the industry that you feel might benefit from it. This includes the SPE of course. Ron and I will be emailing this same information to other people that we know, but your list of contacts is probably broader than ours.
>
> Thanks again and sorry for the delay in getting this out.[13]

The alteration of Rule 4-10 in this manner was not contemplated by the statute enabling the enactment of Rule 4-10, the Energy Policy and Conservation Act ("EPCA"). The EPCA required the SEC to "take such steps as may be necessary to assure the development and observance of accounting practices to be followed in the preparation of accounts by [oil and gas companies]."[14] Although the EPCA required the SEC to "consult with the Secretary [of Energy], the Government Accountability Office, and the Federal Energy Regulatory Commission with

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[12] *E.g.*, SEC 2000 SPE Presentation, Exhibit 7, at SEC00612.

[13] Email from James Murphy, Petroleum Engineer, CorpFin, to Ron Harrell, President, Ryder Scott (July 14, 2000), Exhibit 8, at RS0002083.

[14] Energy Policy and Conservation Act of 1975 § 503 (a), 42 U.S.C.A § 6383(a) (2004).

respect to the accounting practices to be developed . . . .,"[15] the CorpFin Staff does not appear to have complied with the EPCA's requirements in drafting and promulgating the Staff Outline.

D. Staff Outline Amendments to Rule 4-10 Violated APA Requirements

To the extent that the Staff Outline modifies Rule 4-10, it fails to comply with the requirements of the APA and is unenforceable. As detailed in the declaration of James Pearson, provided to the Staff on June 29, 2006, the Staff Outline modifies Rule 4-10 in several respects.[16] These include:

- altering Rule 4-10's "reasonable certainty" standard to a higher level of certainty;[17]
- adding new requirements not found in Rule 4-10 for "developing frontier areas;"[18]
- requiring signed gas sales contracts for booking proved gas reserves;[19]
- requiring formal project sanction before permitting reserves to be booked for a project;[20]
- requiring production license extensions as a precondition to booking reserves beyond current license terms;[21]
- requiring final formal government approvals before booking proved reserves for a project;[22] and
- requiring elimination of potential environmental, political, or commercial uncertainties prior to booking proved reserves.[23]

As recognized by the Office of the General Counsel, the Staff's attempt failed to create a new definition of proved reserves as a matter of law because SEC Staff statements cannot amend the terms of SEC rules.[24] The SEC Staff Outline is unenforceable.

The SEC's August 24, 2004 settled, no admission no denial, enforcement action against Shell stated that Shell engaged in conduct that purportedly violated Rule 4-10.[25] CorpFin Staff sent

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[15] *Id.* § 503 (b)(1), 42 U.S.C.A § 6383(b)(1).

[16] Declaration of James C. Pearson (June 22, 2006) ("Pearson Declaration"), Exhibit 9.

[17] *Id.* at 5.

[18] *Id.* at 7.

[19] *Id.* at 10.

[20] *Id.* at 9.

[21] *Id.* at 11.

[22] *Id.* at 12.

[23] *Id.* at 12.

[24] *See, supra* text accompanying note 9.

comment letters challenging ExxonMobil, Chevron, Total, BP, Norsk Hydro, Statoil, Eni, and others on the same issues. Either the reserves experts at each of these companies were also engaged in fraud or, as is the more reasonable explanation, they believed that the CorpFin Staff was improperly interpreting Rule 4-10's reasonable certainty standard for reporting proved reserves. The entire industry was at loggerheads with the CorpFin Staff on the issues criticized in the SEC Order.

II. Shell Corresponded With SEC Staff Regarding Project Commitment and "Reasonable Certainty"

Shell discussed its views regarding project commitment in correspondence with CorpFin Staff on April 23, 2003. Discussing the point at which Shell believed that a project was "reasonably certain" and therefore reserves could be booked, Shell told the Staff:

> From your question we understand that you would prefer to see very tangible evidence of the intention to develop reserves before said reserves could be booked. Such evidence might include applications for the installation of structures or vessels and the commencement of engineering works. In our opinion, such a strict interpretation would go substantially beyond the intent of the proved reserves definitions regarding "reasonable certainty."[26]

Following an August 6, 2003 meeting between Shell experts and CorpFin Staff discussing this issue and others, such as the Staff's views on lowest known hydrocarbons ("LKH") and the use of pressure gradient and seismic data, Shell noted:

> 1. We believe that the SEC definition and publicly available guidance from SEC staff are ambiguous on the use of pressure gradient and seismic data and are open to interpretations quite different than the ones you discussed with us. For example, the staff's stated views on this topic are not included in recent SEC guidance documents nor any prior publications. We believe that our interpretation of the definition and guidance concerning pressure gradient and seismic data is shared widely (although perhaps not universally) within the industry—this applies in particular to pressure gradient data. . . .
>
> . . .

(... cont'd)

[25] *In the Matter of Royal Dutch Petroleum Company and The "Shell" Transport and Trading Co., p.l.c.*, Exch. Act Rel. No. 34-50233 (Aug. 24, 2004) ("SEC Order").

[26] Letter from Tim Morrison, Group Controller, Shell, to H. Roger Schwall, Assistant Director (Apr. 23, 2003), Exhibit 10, at SEC00742 (copying James Murphy, Petroleum Engineer).

3. We believe that, in the interest of ensuring a common understanding of the regulations by all registrants and investors alike (a "level playing field"), it might be beneficial to have a more widespread and public consultation on these matters.

Further to (3) above, we suggest that this topic would be suitable for both published SEC guidance and discussion at the forthcoming SPEE Forum of US SEC Reserves Definitions in October 2003. For example, this process was used to constructively engage the SEC staff and industry on the production flow testing issue after your view on this topic was covered with both written guidance1 [sic.] and discussed at the 2002 SPEE Forum.

Also we respectfully suggest that other independent industry organizations such as the SPE might be prepared to provide a technical advisory role that the SEC might find to be of value when formulating further guidance to registrants.[27]

Shell was not alone in regarding the Staff's views as contrary to the industry's understanding of Rule 4-10's requirements.

III. CorpFin Staff Views at Odds With Industry Understanding of Rule 4-10

A. ExxonMobil Told SEC Staff Its Comments Affected Industry Wide Issues and Suggested SEC Consult With SPE

Like Shell, other oil and gas companies viewed the Staff's mandates as contrary to the industry's understanding of Rule 4-10's requirements. For example, after the Shell recategorization in January 2004, but well before the SEC's settled Cease and Desist Order with Shell in August 2004,[28] ExxonMobil corresponded with the SEC and commented:

> We believe that a number of the [Staff's] comments, particularly in the reserves area, reflect industry wide issues. These issues cannot be easily resolved through individual company reviews and we strongly support the proposal put forth in the Society of Petroleum Engineers letter dated November 6, 2003 to establish a technical resource group to liase [sic.] with the SEC to enhance common understanding and facilitate resolution of these challenging issues.[29]

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[27] Letter from Tim Morrison, Group Controller, Shell, to H. Roger Schwall, Assistant Director (Sep. 12, 2003), Exhibit 11, at SEC00757 (copying James Murphy and Ronald Winfrey, Petroleum Engineers).

[28] *In the Matter of Royal Dutch Petroleum Company and The "Shell" Transport and Trading Co., p.l.c.*, Exch. Act Rel. No. 34-50233 (Aug. 24, 2004) ("SEC Order").

[29] Letter from Donald D. Humpfreys, Vice President and Controller, ExxonMobil, to H. Roger Schwall, Assistant Director (Feb. 13, 2004), Exhibit 12, at SEC03873 (copying Ronald Winfrey, Petroleum Engineer).

B. ExxonMobil Told SEC Staff Its Staff Outline Was Promulgated Without Notice and Comment and Effectively Amended Rule 4-10

Three months later, ExxonMobil noted its disagreement with the CorpFin Staff's views on proved reserves, the lack of industry-wide guidance, and the fact that the Staff Outline had modified Rule 4-10 in violation of the APA:

> As we have noted in the past, we believe that a number of the issues raised in the course of our correspondence are best addressed on an industry wide basis. We remain concerned that in certain instances, interpretative guidance provided by the SEC staff from time to time can be viewed as effectively amending Regulation S-X without the benefit of the formal rulemaking process, which necessarily involves soliciting input from key parties including industry. We reiterate our support for the establishment of a joint government/industry technical group as the most effective means to chart a path forward for the benefit of all interested parties and to help ensure transparency in the rule making process.[30]

Despite the SEC's knowledge of the widespread concern in the industry about the validity and enforceability of the Staff Outline, the SEC Staff insisted on Shell restating its reserves and promulgated a Cease and Desist Order finding that Shell had committed fraud based upon the Staff Outline rather than Rule 4-10.

IV. CorpFin Staff Coerces Compliance With Staff Outline

The discussed documents demonstrate that expert professionals from major oil and gas companies disagree with the CorpFin Staff on many aspects of the definition of proved reserves. These industry experts believe that CorpFin Staff was enforcing disclosure requirements not found in Rule 4-10 and that were more stringent than the rule's "reasonable certainty" standard.

The CorpFin Staff's correspondence with registrants generally asserts that

> The purpose of our review process is to assist you in your compliance with the applicable disclosure requirements and to enhance the overall disclosure in your filing. We look forward to working with you in these respects. We welcome any questions you may have about our comments or on any other aspect of our review.[31]

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[30] Letter from Donald D. Humpfreys, Vice President and Controller, ExxonMobil, to H. Roger Schwall, Assistant Director (May 24, 2004), Exhibit 13, at SEC03960-61 (copying Ronald Winfrey, Petroleum Engineer).

[31] *E.g.*, Letter from H. Roger Schwall, Assistant Director, to Mr. Mincato, Managing Director and Chief Executive Officer, Eni (Apr. 17, 2003), Exhibit 14, at SEC00496 (directing questions regarding property disclosures to James Murphy, Petroleum Engineer).

However, the Staff does not "merely suggest" that registrants consider its views. Rather, CorpFin Staff directs oil and gas registrants to follow its restrictive interpretations of Rule 4-10's reasonable certainty requirements. The language is blunt:

> 2. . . . Unlike most of our comments, prior comment 2 was only intended as a suggestion.
>
> Unfortunately, it appears as though you misconstrued a number of our other comments, believing that they were merely suggestions.[32]

A. Reasonable Certainty

The CorpFin comment letters set requirements to establish "reasonable certainty" that move the standard towards "absolute certainty."[33] For example:

- Demanding "formal approval of the [development] plan by the governing authorities" before agreeing with disclosure of proved reserves associated with a project;[34]
- Mandating that "gas sales contracts are an unavoidable requirement" before booking proved reserves;[35]
- Requiring "compelling evidence" of "established, robust gas market capacity" prior to booking proved reserves;[36] and

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[32] Letter from H. Roger Schwall, Assistant Director, to Charles Paris de Bollardière, Treasurer, Total (July 11, 2003), Exhibit 15, at SEC00404 (directing questions on engineering comments to Ronald Winfrey, Petroleum Engineer).

[33] Cambridge Energy Research Associates, In Search of Reasonable Certainty: Oil and Gas Reserves Disclosure (Feb. 2005), Exhibit 16, at 15 ("2005 CERA Report). The February 2005 report by Cambridge Energy Research Associates ("CERA") was sponsored by major oil and gas companies, petroleum engineering consulting firms, and auditing firms, including: Amerada Hess; Anadarko Petroleum; Apache; BP; ChevronTexaco; ConocoPhillips; DeGolyer and MacNaughton; Deloitte & Touche; Eni; ExxonMobil; Kerr-McGee Oil and Gas; KPMG; Marathon Oil Company; Netherland, Sewell & Associates; Occidental Petroleum; PricewaterhouseCoopers; Ryder Scott; and Total.

[34] Letter from H. Roger Schwall, Assistant Director, to Daniel B. Pinkert, Corporate Secretary, BP (Dec. 9, 2003), Exhibit 17, at SEC00564 (directing questions regarding engineering comments to Ronald Winfrey, Petroleum Engineer).

[35] Letter from H. Roger Schwall, Assistant Director, to Eivind Reiten, President and Chief Executive Officer, Norsk Hydro (Jan. 9, 2004), Exhibit 18, at SEC00474 (directing questions regarding engineering comments to Roger Baer, Mining Engineer, and Ronald Winfrey, Petroleum Engineer).

[36] Letter from H. Roger Schwall, Assistant Director, to Daniel B. Pinkert, Corporate Secretary, BP (Feb. 13, 2004), Exhibit 19, at SEC00579.

- Refusing to recognizing the reasonable certainty of license renewals "without conclusive, unambiguous support."[37]

In light of the inherent, intended flexibility of Rule 4-10's "reasonable certainty" standard, the Staff's insistence upon strict adherence to its views—rigid, inflexible, and at odds with the views of most oil and gas industry experts—appears misplaced.

B. Formal Government Approvals—Kashagan and Other Examples

Rule 4-10 does not require formal government approval of development plans to satisfy reasonable certainty. The CorpFin Staff does. The Staff insists, contrary to industry understanding, that undeveloped reserves cannot be booked as proved until "formal approval by the governing authorities" of development plans.

1. Kashagan Example

Kashagan is a large oil field project in Kazakhstan. The partners on Kashagan include Shell, ExxonMobil, BP, Total, and Eni. During 2002, the partners issued a "declaration of commerciality" for the Kashagan project. Several project partners, including Shell, booked proved reserves for Kashagan. The CorpFin Staff took exception.

a. Total Booked Kashagan Upon Consortium's Commitment to Develop and Prior to Formal Government Approval of Development Plan

In a letter dated October 7, 2003, CorpFin Staff wrote Total:

> Ryder Scott states that no proved SEC reserves can be assigned until the DP&B [development plan and budget] and KEPDS [?] has been approved by the RoK [Republic of Kazakhstan] and the current political risk is reduced." As the effective date of the Ryder Soctt report is 1-1-03, it appears that this document does not support your year-end 2002 attribution of proved reserves to Kashagan.[38]

In November 2003, Total informed the Staff:

> We would like to clarify our use of the technical data in the Ryder Scott report.

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[37] Letter to Total (July 11, 2003), *supra* note 32, at SEC00417.

[38] Letter from H. Roger Schwall, Assistant Director, to Charles Paris de Bollardière, Treasurer, Total (Oct. 7, 2003), Exhibit 20, at SEC04549 (directing questions on engineering comments to Ronald Winfrey, Petroleum Engineer) (alterations in original, stand-alone quotation mark in original).

> As stated in the August 6, 2003 submission and discussed with the SEC by telephone on September 22, 2003 and in Annex A to the response letter of September 24, 2003, Total believes that the Kashagan reserve information in the 2002 Annual Report on Form 20-F was appropriate when the Form 20-F was prepared and that it continues to be appropriate today. We further believe that the technical information and evaluation which we have furnished to you supports our position and that the independent technical evaluation of the Kashagan reserves performed by Ryder Scott, which we cited solely as an additional support for our own technical analysis, confirms our evaluation of the Kashagan reserves.
>
> We have never contended that the Ryder Scott report, which we submitted to you only at your request, otherwise supports our decision to book the Kashagan reserves, and, indeed, we do not concur with Ryder Scott's opinion that a decision to book proved undeveloped reserves cannot be made until the development plan and budget has been officially approved by the Kazakhstan authorities. Rather, it is our view that, in line with the SEC guidance, proved undeveloped reserves can be booked on the basis of a commitment by the company to develop the necessary production, treatment and transportation infrastructure and that affirmation of such commitment may take various forms. Moreover, with respect to the political risk situation in Kazakhstan, at the time Total made the decision to book the Kashagan reserves, we believed, as we continue to believe, that the level of political risk associated with the Kashagan project is acceptable and will not jeopardize the successful development of the project as currently envisaged.
>
> In the specific case of Kashagan, Total decided to book proved reserves on Kashagan at year end 2002 based on the commitment of the Consortium and Company to develop the field.[39]

Shell booked Kashagan at the same time as Total.

In its response to Total, the CorpFin Staff told Total that booking proved reserves in Kashagan was improper absent formal approval of the plan of development by the host government:

> 2. In our prior comment 2, we asked, in part, that you tell us the changes in the status of development plan's approval by the Kazakh government. Your response addressed the consortium's commitment to the Kashagan project but did not address whether the Kazakh government has approved the formal plan of development. Generally, our position is that the formal plan must be approved before proved reserves can be claimed by the contractor. Without formal approval by the governing authorities, the plan's capital expenditures, timing of those expenditures and associated projected production and cash flows do not have reasonable certainty of realization. Without official approval

[39] Letter from Charles Paris de Bollardière, Treasurer, Total, to Ronald Winfrey, Petroleum Engineer (Nov. 4, 2003), Exhibit 21, at SEC04556-04557.

of the consortium's formal plan of development by the Kazakh government, we will object to your claim to proved reserves in the Kashagan project.[40]

b. Total and ExxonMobil Maintain They Were Right to Book Kashagan Prior to Formal Government Approval

Following Shell's recategorization announcement in January 2004, in which Shell debooked its Kashagan reserves, industry commentators noted that Total and ExxonMobil were carrying the Kashagan reserves at year-end 2003, just as Shell was de-booking them. Total's Chief Executive, Thierry Desmarest, commented, "We have every reason to book these reserves, we had every reason to book them last year."[41]

During a March 11, 2004 analyst meeting, an analyst asked ExxonMobil Corp. ("ExxonMobil") executives about the criteria used by for booking reserves in Kashagan. Rex Tillerson, then ExxonMobil's President, stated,

> As you know, the standard by which the Securities and Exchange Commission holds us as to our bookings is one of 'reasonable certainty'. . . . At some point, we conclude that we are, in effect, committed to a project in terms of both our financial and technical decision to go forward. . . . There is no specific criteria regarding the government formally approving or disapproving a development plan. Obviously, you must have the rights to the resources and you must have confidence that you can obtain all necessary approvals. . . . So our judgment—speaking directly to Kashagan—is that the issues that are outstanding, that would allow us and the consortium to make a decision to go forward, as well as the government's acceptance of the basis upon which we can go forward,—an expectation that we now have a common understanding and a common commitment to move this resource forward and confidence that, in fact, that's now in place and going to happen—that was our basis for taking the proved reserves in 2003. We had achieved several milestones with the government—from a technical standpoint, the development concept, of which they had already indicated their approval. The timing of their final approval of the DP&B (Development Plan and Budget) was something that was imminent. And we could see that it was imminent. We don't wait on that

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[40] Letter from H. Roger Schwall, Assistant Director, to Charles Paris de Bollardiere, Group Treasurer, Total (Nov. 19, 2003), Exhibit 22, at SEC00425 (directing questions regarding engineering comments to Ronald Winfrey, Petroleum Engineer).

[41] Tom Cahill, *BP Sees More Reserves Than Shell From Stake in Norwegian Field*, Bloomberg.com (Apr. 1, 2004) <http://quote.bloomberg.com/apps/news?pid=10000102&refer=uk&sid=aQcmiERGUz90#>, Exhibit 23.

> necessarily in every development, again, because it's a function of all those elements that I just described.[42]

Lee Raymond, ExxonMobil's then Chairman and Chief Executive Officer, added, "If what I read in the paper was correct, the statement was made that we are the most conservative and rigorous and disciplined in how we deal with the reserves issue. That applies to every decision we make on reserves. And that has been a process that has been in place for a long, long time. We make judgments on each one, consistent with that process that has been in place for a long time."[43]

c. SEC Staff Did "Not Object" to Kashagan Reserves For ExxonMobil and Total

At the time the SEC Staff provided comments on Kashagan in a March 29, 2006 letter to ExxonMobil, the Staff maintained that the booking was improper but appeared to have changed its mind about requiring registrants to delete the Kashagan reserves:

> 7. We do not concur with your attribution of proved reserves to Kashagan before the formal approval by the Kazakh government of this project's final development plan. Since you have subsequently obtained approval, we will not object to your inclusion of these reserves in your 2003 Form 10-K provided you satisfy our comments below. [Requested details regarding booked volumes.][44]

A similar concession had been made to Total in a letter dated March 11, 2004.[45]

d. ConocoPhillips Did Not Book Kashagan

Different companies book or do not book reserves for different reasons at different times. For example, the SEC asked ConocoPhillips in an April 12, 2004 letter:

> How many proved reserves have you booked in the Kashagan field? When you and the other contracting companies declared the field commercial in 2002 did you book proved

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[42] Exxon Mobil Corp., *Presentations and Q&A Session, Analyst Meeting*, at 34-35 (Mar. 10, 2004), Exhibit 24, <http://www2.exxonmobil.com/corporate/files/corporate/Transcript_2004_Analyst_Meeting.pdf>.

[43] *Id.*, at 35-36.

[44] Letter from H. Roger Schwall, Assistant Director, to Donald D. Humphreys, Vice President and Controller, ExxonMobil (Mar. 29, 2004) Exhibit 25, at SEC00487 (directing questions regarding engineering comments to Ronald Winfrey, Petroleum Engineer).

[45] Letter from H. Roger Schwall, Assistant Director, to Charles Paris de Bollardiere, Group Treasurer, Total (Mar. 11, 2004), Exhibit 26, at SEC00432 (directing questions regarding engineering comments to Ronald Winfrey, Petroleum Engineer). Based upon the produced correspondence, the Staff also seems not to have revisited with BP the issue of formal government approval of development plans.

reserves at that time? If so, what was the basis of this booking since the government had not approved the development plan?

ConcoPhillips responded:

Response: We have not booked any proved reserves for the Kashagan field.[46]

This provides an example of a company that had not booked proved reserves in Kashagan when its project partners had done so, Total and Shell at end 2002 and ExxonMobil at end 2003.

e. SEC Treatment of Shell Inconsistent

In contrast to the SEC's treatment of Total's and ExxonMobil's booking of Kashagan, the SEC Order found that Shell had committed securities fraud in booking Kashagan reserves prior to the Kazakh government's formal approval of the project development plan. This is inconsistent.

These examples serve to demonstrate that the SEC knew that reputable companies booked proved reserves that they believed were "reasonably certain," making the judgment that they were committed to the project and that necessary formal government approvals would be forthcoming. The Staff did not require these companies to restate such reserves.

2. Other Examples

a. BP Booked Proved Reserves Prior to Formal Government Approval

In a December 2003 letter to BP regarding proved reserves requiring government approval of development plans, the Staff commented,

> 34.e) Where approval by the host government of a project's formal, final development plans is required, such approval generally must be accomplished before proved reserves can be validly claimed. . . . Without formal approval of the plan by the governing authorities, the estimated future production does not have reasonable certainty of realization and cannot be claimed as proved reserves. Supplementally, affirm to us that you have not claimed significant proved reserves without such approval or amend your document to delete such volumes from your disclosed proved reserves.[47]

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[46] Letter from John A. Carrig, Executive Vice President, Finance, and Chief Financial Officer, ConocoPhillips, to H. Roger Schwall, Assistant Director (Apr. 23, 2004), Exhibit 27, at SEC03196.

[47] Letter to BP (Dec. 9, 2003), *supra* note 34, at SEC00564.

BP responded that it had booked proved reserves in advance of host government approval in two instances:

> BP affirms that at December 31, 2002 we had not claimed reserves in advance of host government formal development approval with the following two exceptions: Trinidad Train 4 project and Terang/Sirasun.[48]

BP projected that the Trinidad Train 4 project would be the largest in the world and the Terang/Sirasun fields carry 1 TCF of proved gas reserves.[49] It is noteworthy that (i) BP's response was to an SEC comment letter sent prior to the Shell recategorization announcement on 9 January 2004; (ii) these are two large examples of booking without formal government approval, but on the basis of reasonable certainty; and (iii) this answer is based on BP's proved reserves as of December 31, 2002 and so does not cover the booking by BP of Ormen Lange at end 2003.

b. ExxonMobil Told SEC Staff That Government Approvals of "Final Development Plans" Are Not Correct Barometers of "Reasonable Certainty"

On the general issue of formal government approvals, ExxonMobil told the CorpFin Staff in May 2004:

> We believe that no reserves have been booked contrary to the SEC interpretative guidance regarding governmental approvals, although we note that such guidance has varied over the past few years. Development plans on a major project continually evolve through interactions with both co-participants and host governments. On large, long lived projects, there may never be a "final development plan" as the field's development evolves based on technology advances and information obtained from actual production. We believe that companies can become reasonably certain of government approval of a project based on a progressive series of actions prior to the actual signing of a "final development plan," if, indeed, any such "plan" is even required or subject to a "final approval." From our perspective, the key barometer of whether a company believes that any necessary government approvals will be obtained is best evidenced by financial commitments. In our case, we are only willing to make significant funding commitments

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[48] Letter from Byron E. Grote, Chief Financial Officer, BP, to H. Roger Schwall, Assistant Director (Jan. 12, 2004), Exhibit 28, at SEC02249 (copying Ronald Winfrey, Petroleum Engineer).

[49] Trinidad Train 4 was approved by the Trinidad government in June 2003, after BP had booked reserves. BG Group Country Operations, Trinidad and Tobago, available at http://www.bg-group.com/international/int-trinidad.htm, scroll to "Atlantic LNG" ("Train 4 with 5.2 mtpa output from around 800 mscfd of gas will be the largest train in the world . . ."). Terang/Sirasun together represent 1 TCF of proved gasreserves , as certified by DeGolyer & MacNaughton. Circular to Shareholders, PT Energi Mega Persada Tbk., at 14, available at http://www.energi-mp.com/uploads/ Shareholders %20Circular%20English.pdf.

on a project if we believe there is a high probability of securing any necessary government approvals. We believe this approach is consistent with the principle and meets the standard of "reasonable certainty".[50]

C. Gas Contracts/Robust Gas Market Are Not Rule 4-10 Requirements

Rule 4-10 does not require that "gas sales contracts are an unavoidable requirement," "compelling evidence of established, robust gas market capacity," or "pipeline and facilities are built" are required to report proved gas reserves. The CorpFin Staff does.

For example, during the 2000 SPE presentation, the Staff stated:

- If there is no pipeline they are stranded reserves. Not proved until:

  1) an approved sales contract exists;

  2) pipeline and facilities are built.[51]

1. BP Informed SEC Staff Gas Contracts Not Required By Rule 4-10

In response to a December 9, 2003 SEC comment letter requesting that BP, "Affirm to us that you have gas sales contracts for those operating areas (e.g. Rest of World) that are without robust gas markets,"[52] BP responded:

> Although gas sales contracts are not explicitly required for reserve booking under SEC rules, it is BP's practice that reserves are not added until a sales contract has been agreed in those areas not served by an established gas market. We therefore affirm that our proved gas reserves are either covered by a gas sales contract or that there is a robust gas market where we are reasonably certain of being able to sell the gas. Examples of the latter include most of Europe and North America but also include a component of the domestic gas sales in Indonesia, extensions to domestic gas and LNG Trains 1-3 contracts in Australia and the Trinidad Train 4 volumes. In the case of Australia, booking reserves beyond contract is based primarily on the fact both that (a) current contracts expire in 2005 and 2009 and the facilities have at least 30 years of remaining useful life and that (b) ample gas volumes at a highly competitive cost of supply have been demonstrated to exist in the licence areas. In the case of Trinidad, we had preliminarily gas sales

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[50] Letter from ExxonMobil (May 24, 2004), *supra* note 29, at SEC03960.

[51] SEC 2000 SPE Presentation, *supra* note 12, at SEC00607 (slide entitled "No Sales Market Established:").

[52] Letter to BP (Dec. 9, 2003), *supra* note 34, at SEC00563.

> agreements at the end of 2002, which together with government assurances of support, were considered sufficiently firm to book reserves and start construction work.[53]

BP did not believe that a gas sales contract is a Rule 4-10 requirement. In addition, BP cited to the robust gas markets in Europe and North America to which gas may be sold. BP cited numerous examples of gas reserves booked where they are reasonably certain of being able to sell the gas without necessarily having contracts in place.

In a February 2004 letter, the CorpFin Staff told BP:

> 39. [Y]ou have booked Australian proved gas reserves beyond the life of the sales contracts. Supplementally, tell us the portion of these claimed proved reserves that are not contracted. Explain which markets are currently available to these uncontracted volumes. Be advised that we require compelling evidence of established, robust gas market capacity for such volumes.
>
> You have also booked proved gas reserves in Trinidad without firm gas sales contracts. Generally, we object to such premature claims of proved reserves for those situations where a gas sales contract is necessary for a project to proceed. Affirm to us you will not claim proved reserves without an executed contract in such situations in future documents.[54]

BP responded on March 31, 2004. However, BP requested confidential treatment of certain of its responses, including responses to this Staff comment, and the SEC has failed to produce these communications.[55]

2. Norsk Hydro Informed SEC Staff Gas Contracts Not Required and Discussed Ormen Lange Field

A January 9, 2004 SEC comment letter addressed to Norsk Hydro stated:

> 91. We note your statement "Because of the increasing liquidity of the European gas market, Hydro no longer views having new long-term gas sales contracts in place as a prerequisite for making investment decisions for new gas fields – such as the Ormen Lange field." Be advised we believe that gas sales contracts are an unavoidable

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[53] Letter from BP, (Jan. 12, 2004), *supra* note 48, at SEC02248.

[54] Letter to BP (Feb. 13, 2004), *supra* note 36, at SEC00579.

[55] *See* Letter from Byron E. Grote, Chief Financial Officer, BP, to H. Roger Schwall, Assistant Director (Mar. 31, 2004), Exhibit 29, at SEC02275, SEC02279 (comment 39).

requirement for the attribution of proved gas reserves for those operating areas that are without robust gas markets.[56]

On February 13, 2004, Norsk Hydro's counsel, Donald Meiers, Esq., of the Washington, DC office of Steptoe & Johnson LLP, responded on behalf of Norsk Hydro:

Response

Ormen Lange will be developed based on export to the UK through a new pipeline being constructed from the field to Easington in England. The UK is the most liberalised gas market in Europe. In this market roughly 50% of the gas is bought and sold over the short-term market, with a virtual point – the National Balancing Point (NBP) – as the price reference. In addition to the physical gas flow that takes place after a transaction, there may be many short-term and financial transactions carried out for balancing and optimisation of gas portfolios, hedging and risk management etc. The other 50% of the gas is bought under bilateral contracts where the buyer takes the gas at an agreed upon delivery point. These contracts may be both short- and long-term, but the terms and conditions are usually not public information.

After the liberalization of the UK gas market in 1992, liquidity in the short-term market has increased rapidly. Since 1996, traded volumes on the NBP have doubled each year and current volumes are comparable to the total European physical demand. This is illustrated below (volumes in billion cubic meters) and demonstrates that the UK is a liquid market for gas (see illustration 1).

The UK is Europe's largest gas market at 100 bcm (2002), with an expected demand growth of 1,1% per annum. Domestic gas production is forecasted to decrease rapidly after 2005, making the market increasingly import dependent, and creating a robust gas demand picture for new imports. This shown in the illustration below of UK demand and supply which is taken from National Grid Transco report, Transporting Britain's Energy 2003 (see illustration 2). This is also stated in the joint statement of the Norwegian and UK energy ministers of October 2, 2003 (see exhibit 2): *"The UK, notwithstanding the important efforts to prolong the productive life of the UK Continental Shelf, is expected to become a net importer of gas later in this decade and consumers will need substantial supplies of new gas. The UK therefore sees Norway as an attractive source of gas to contribute to the UK's future diversity and security of energy supply in line with UK's recent Energy White Paper."*

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[56] Letter to Norsk Hydro (Jan. 9, 2004), *supra* note 35, at SEC04056.

> Due to the liquidity of the UK market and the projected development in supply and demand, Hydro has not seen entering of long term contracts to be a prerequisite for deciding upon the development of the Ormen Lange field.[57]

The CorpFin Staff apparently believes the North European gas market is not "robust." Meanwhile, companies make major investment decisions for gas projects without having long-term sales contracts.

Norsk Hydro believed that the sale of Ormen Lange gas was reasonably certain, notwithstanding the fact that the gas is not contracted for and in contrast with the views expressed by the SEC Staff. Norsk Hydro's assessment of the gas as "reasonably certain" as required by Rule 4-10 was evident from the company's commitment to progress the development of the major Ormen Lange field, for which Norsk Hydro is the development operator.

3. Repsol Did Not Believe Rule 4-10 Required Gas Contracts

An SEC letter dated June 23, 2004 addressed to Repsolf YPF, S.A. ("Repsol") commented:

> 18. Regarding your response number 78 it does not appear that the Far East reserves from the Pulau Gading field have met the requirements under Rule 4-10(a) of Regulation S-X for proved reserves. Under the existing conditions, you have been unable to find a market for your reserves. Further, a development for the gas reserves has yet to be approved but you booked the reserves in 1999. Therefore please remove these reserves from your proved reserves classification.[58]

On July 19, 2004, Michael J. Willisch, Esq., of the Madrid, Spain office of Davis Polk & Wardwell ("Davis Polk"), responded on behalf of his client:

> As discussed in our response to prior comment 78 of the Staff's letter of April 16, 2004, a liquids only plan of development (POD) for the Jambi Merang Block, which includes the Pulau Gading Field, was approved by the Indonesia Authority in December 2001, and a revised POD for a combined gas and liquids development was submitted for approval in October 2002.
>
> A prerequisite to the approval of the POD was the execution of a heads of agreement relating to gas sales. In clarification of our prior response, though the partners of the Jambi Merang Block (Pertamina, Amerada Hess and Repsol YPF) substantially agreed a

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[57] Letter from Donald Meiers, Esq., Steptoe & Johnson LLP, to Susan L. Min, Esq., et al., SEC (Feb. 13, 2004), Exhibit 30, at SEC04134.

[58] Letter from H. Roger Schwall, Assistant Director, to Carmelo de las Morenas Lopez, Chief Financial Officer, Repsol (June 23, 2004), Exhibit 31, at SEC04923 (copying James Murphy, Petroleum Engineer).

> heads of agreement with ETJ, a gas aggregator, during April 2004, the agreement was entered into in July 2004. This heads of agreement establishes the main terms and conditions, which will be included in the definitive gas sales agreement to be entered into among the parties, under which Pertamina, Amerada Hess and Repsol YPI will sell, and ETJ will purchase, gas from the Pulau Gading and Sungai Kenawang fields. Sungai Kenawang is a gas condensate field, in the Jambi-Merang Block PSC, discovered and delineated in year 2001.
>
> In advance of the anticipated execution of the heads of agreement, a preliminary POD was delivered to BPMigas, the state petroleum agency, for comment in early June 2004. The final POD is expected to be submitted to BPMigas before the end of July 2004. Repsol YPF believes that BPMigas will approve the final POD within an estimated two months following its submission. While such delivery and approval is pending, the joint operating body is progressing with its implementation program, which includes contract awards and all of the required investments to achieve the target on-stream date for first gas deliveries.
>
> In light of the foregoing, Repsol YPF believes the booked proved gas reserves for Pulau Gading currently meet the reasonable certainty to be recoverable requirements of Rule 4-10(a) of Regulation S-X.[59]

For many years leading oil and gas companies with the knowledge of their counsel, including Davis Polk, have booked proved gas reserves on the basis of reasonable certainty rather than the criteria introduced in the SEC Staff Outline and comment letters. The SEC Staff knew this before the Shell recategorization and the companies reiterated their position prior to the SEC Order, which used the Staff Outline as the basis for a finding of fraud. In any event, the requirement for gas contracts is not found in Rule 4-10 and the Staff's insistence that such contracts "are an unavoidable requirement" is wrong.

D. Formal License Renewal

Production licenses and their renewal are not addressed in Rule 4-10. The only requirement is "reasonable certainty" of renewal.[60] The CorpFin Staff position is that host government renewal of production licenses is a "prime consideration" for booking proved reserves and that booking reserves past license is invalid without "conclusive, unambiguous support."

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[59] Letter from Michael J. Willisch, Esq., Davis Polk & Wardwell, to H. Roger Schwall, Assistant Director (July 19, 2004), Exhibit 32, at SEC04936-37.

[60] *See* Pearson Declaration, *supra* note 16, at 11.

1. Chevron Told SEC Staff Reserves May be Booked Beyond License If Management Believed It Would Successfully Renew Licenses

In response to an SEC comment letter dated February 26, 2001, Terry M. Kee, Esq., of Pillsbury Winthrop LLP replied on behalf of Chevron Corp. ("Chevron"):

> 100. Will you produce all the proved reserves from the Chevron Nigeria Limited concession before it expires in 2008?
>
> Chevron believes that it will not produce all of the proved reserves associated with two offshore leases, OML 90 and 95, prior to lease expiration in 2008. However, Chevron's management believes that it will be successful in renewing these offshore concessions. The basis for that belief is Chevron's demonstrated history of obtaining renewals in Nigeria under the same Petroleum Act. In 1999, for example, Chevron renewed OMLs 49, 50, 51, 52, 53, 54 and 55. These were operated in the absence of a renewal for one year without any negative ramifications.
>
> The requirements for lease renewal are straightforward. As stated in the Petroleum Act, ". . . renewal shall be granted if the lessee has paid all rent and royalties due and has otherwise performed all obligations under the lease." Chevron believes that is clearly meeting these obligations for OML 90 and 95. Chevron also advises that it is committing $2.2 billion in investment in gas projects in Nigeria that are connected to potential gas reserves beyond the 2008 concession date. Additionally, Chevron is aware of no major operator ever being denied renewal on a productive lease.[61]

The SEC Staff did not challenge Chevron's view regarding carrying proved reserves in Nigeria beyond the end of its current licenses.

The license expiration issue precipitated significant discussion within Shell in 2002 and was resolved with a legal opinion at the end of 2002 that, similar to Chevron's understanding cited above, Shell was entitled to license extensions in Nigeria and thus beyond-license reserves were not at risk.

In contrast to the SEC Staff's treatment of Chevron, the SEC Order found that Shell had committed fraud in this regard in part because proved reserves in SPDC Nigeria were "constrained by license expiration and depended on unrealistic production forecasts."[62] As discussed in Watts' submissions to the Staff, there were no license constraints in SPDC Nigeria

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[61] Letter from Terry M. Kee, Pillsbury Winthrop LLP, to H. Roger Schwall, Assistant Director (Apr. 11, 2001), Exhibit 33, at SEC02693 (copying James Murphy, Petroleum Engineer).

[62] SEC Order, *supra* note 25, at 10.

and production forecasts were viewed as achievable based on funding and operational considerations and the forecasts were achieved through at least mid-2004.[63]

2. Total Told SEC Staff It Booked Beyond License Where Company Had Renewal Rights

Two years after Chevron's response, Total told the CorpFin Staff about two countries, Nigeria and Congo, where reserves were booked in anticipation of license renewal.

In a July 11, 2003 letter, the SEC commented:

> We consider the history of oil and gas production license renewals by the pertinent authorities to be a prime consideration in the attribution of proved reserves. If there is an applicable record of non-renewals or no record, we would not consider the attribution of proved reserves past license expiry to be valid without conclusive, unambiguous support.[64]

Total responded to the CorpFin Staff's comments on August 6:

> Only the amount of Total's net proved reserves that are estimated to be recoverable during the remaining terms of the appropriate concessions or production sharing agreement have been included, taking into account renewal rights to which the company is entitled according to the terms of the concessions or agreements.
>
> In practice, we have considered such right of renewal according to the terms of the concessions or agreements for an amount totaling 214 Mboe, the main contributors being:
>
> - Nigeria: approximately 200 Mboe in OMLs 99, 100 and 102. According to the terms of the contract, the lessee of an OML shall be entitled to apply in writing to the minister, not less than twelve months before the expiration of the lease, for a renewal of the lease either in respect of the whole of the leased area or any particular part thereof, and the renewal shall be granted if the lessee has paid all rent and royalties due and has otherwise performed all his obligations under the lease. Furthermore, to our knowledge, there is no record of non-renewal in Nigeria under those contractual terms; and

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[63] Watts has no information regarding SPDC Nigeria production performance since mid-2004 although, due to serious civil unrest during 2005 and 2006, Shell has publicly stated that production in Nigeria has been disrupted.

[64] Letter to Total (July 11, 2003), *supra* note 32, at SEC00417.

- Congo: around 11Mboe. A five-year renewal assumption is taken into account, in line with the terms of the licenses, which grant the lessee the right to such an extension. To our knowledge, there is no record of non-renewal in Congo under those contract terms.[65]

For more than two years before the Shell recategorization, SEC staff were aware of major companies carrying reserves that would be produced after licenses expired in Nigeria and elsewhere on the basis of reasonable certainty of license renewal. Other examples came to light after the Shell recategorization, but before the SEC Order.

3. Repsol Booked Proved Reserves Beyond License Based On Right to Renew

SEC Staff (and Davis Polk which represented Repsol) knew that Repsol had proved gas reserves booked beyond the current license term. An SEC letter dated April 16, 2004, commented:

> Confirm that the terms used to deplete your capitalized costs related to your proved properties do not extend beyond the remaining terms of the related leases or contractual rights under which they are held. If depletion of these assets is expected to extend beyond the contractual terms, you must be able to demonstrate an ability to renew these rights as supported by historical experience.[66]

On behalf of Repsol, Davis Polk replied to the Staff:

> With the exception of Argentina (discussed separately below), Repsol YPF confirms to the Staff that the terms used to deplete its capitalized costs related to proved properties do not extend beyond the remaining terms of either our license agreements or the other legal and contractual agreements that support our right to produce oil and gas.
>
> . . .
>
> Also, for clarification purposes it should be noted that, as of December 31, 2002, 234 million of BOE of proved reserves have been granted on extensions in the Romos and Loma La Lata-Sierra Barrosa fields. Only 101 million of BOE (which represent 1.9% of Repsol YPF's total net proved reserves as of that date) relate to such future ten-year extensions. Such reserves are mainly located in oil fields subject to mature water-flooding projects with high water cuts (in excess of 90%) and stabilized low oil decline

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[65] Letter from Charles Paris de Bollardière, Treasurer, Total, to Alex Shukhman, SEC (Aug. 6, 2003), Exhibit 34, at SEC04546 (copying Ronald Winfrey, Petroleum Engineer).

[66] Letter from H. Roger Schwall, Assistant Director, to Carmelo de las Morenas Lopez, Chief Financial Officer, Repsol (Apr. 16, 2004), Exhibit 35, at SEC04778 (directing questions on engineering comments to James Murphy, Petroleum Engineer).

> rates, and also in some non-operated large gas fields (Aguada Pichana and Aguaragüe concessions). Currently, the amount of proved reserves reported which corresponds to such renewals is progressively decreasing, since oil production is being accelerated through additional infill development programs and also as a result of the significantly increasing domestic gas demand in Argentina.[67]

There must be a standard to judge whether it is a "reasonable certainty" that a license will be renewed. However, the requirement of "conclusive, unambiguous support," not found in Rule 4-10, sets a higher bar than "reasonable certainty."

E. Technical Issues

In addition to the issues discussed above, there is significant industry disagreement with the CorpFin Staff regarding technical issues that arise under Rule 4-10. The SEC Order found that Shell committed fraud because of two such technical issues: reserves below the level of the lowest fluid contact, or "lowest known hydrocarbon" ("LKH") and year-end prices.

1. Lowest Known Hydrocarbon

Rule 4-10 states, "In the absence of information on fluid contacts, the lowest known structural occurrence of hydrocarbons controls the lower proved limit of the reservoir."[68] The Staff Outline states

> In order to attribute proved reserves to legal locations adjacent to such a well (i.e. offsets), there must be conclusive, unambiguous technical data which supports reasonable certainty of production of such volumes and sufficient legal acreage to economically justify the development without going below the shallower of the fluid contact or the LKH. In the absence of a fluid contact, no offsetting reservoir volume below the LKH from a well penetration shall be classified as proved.
>
> Upon obtaining performance history sufficient to reasonably conclude that more reserves will be recovered than those estimated volumetrically down to LKH, positive reserve revisions should be made.

Oil and gas companies disagree with the CorpFin Staff's view that no reserves below LKH may be considered as proved under Rule 4-10. The industry has been working with 3D seismic and pressure gradient methodologies for years. Using such technology, many companies developed

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[67] Letter from Michael J. Willisch, Esq., Davis Polk & Wardwell, to H. Roger Schwall, Assistant Director (June 3, 2004), Exhibit 36, at SEC04816.

[68] Rule 4-10(a)(2)(i).

"information on fluid contacts" below LKH, as required by Rule 4-10, sufficient to book such reserves as proved. As shown in the examples below, the SEC Staff disagreed.

a. SEC Staff Instructed Eni to Limit Proved Reserves to LKH

The CorpFin Staff told Eni that pressure gradient data was insufficient and "not consistent with the intent or spirit of the SEC rules for proved reserves" and instructed Eni to "limit proved reserves to the lowest know[n] hydrocarbon from a well penetration."[69]

b. ExxonMobil Told SEC Staff Rule 4-10 Permits Booking Below LKH Where Supported by Technical Data

In a March 2004 letter to ExxonMobil, the CorpFin Staff stated,

> 11. . . . [ExxonMobil has] attributed proved reserves to intervals below lowest known hydrocarbon. Your position that "Based on the quality and consistency of the pressure gradient data, we believe that the hydrocarbon contact has been accurately determined." is not consistent with your disclosure that you require, at a minimum, well logs, pressure data, fluid samples and core data for proved reserve determination. . . . Amend your current documents to remove material volumes claimed as proved reserves that are attributed below lowest known hydrocarbon as determined by a well penetration and assessment. In future documents, refrain from disclosing any such volumes.[70]

In response to the CorpFin Staff's request for information about proved reserves booked below LKH, ExxonMobil quantified such reserves and the basis on which it had booked these proved reserves: "reasonable certainty" of the hydrocarbon contact.

- Our detailed review found a total 59 million barrels of oil equivalent booked below lowest known hydrocarbon at year-end 2003. In general, where adequate technical information exists, we believe it appropriate to book proved reserves below lowest known hydrocarbon. As discussed further in out detailed response, we are treating these barrels in accordance with our understanding of the applicable rule.

. . .

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[69] Letter from H. Roger Schwall, Assistant Director, to Mr. Mincato, Managing Director and Chief Executive Officer, Eni (June 13, 2003), Exhibit 37, at SEC00506 (directing questions regarding engineering comments to James Murphy, Petroleum Engineer). In July 2003, Mr. Schwall told Shell that the Staff viewed use of pressure gradient data to attribute proved reserves below LKH as inappropriate and commented "Nor do we agree with your contention that your view is shared widely across the industry." Letter to Shell (July 10, 2003), *supra* note 7, at SEC00192.

[70] Letter to ExxonMobil (Mar. 29, 2004), *supra* note 44, at SEC00488.

> Under strict quality measures, quality and consistency of pressure data can form the basis of reasonable certainty of he hydrocarbon contact, and the hydrocarbon volumes which may be claimed as proved.[71]

The SEC Staff knew that major companies had for years booked reserves below LKH believing that their approach satisfied Rule 4-10.

c. Entire Industry Believes SEC Staff Lagging Behind Industry's Improved Technological Tools

The 2005 CERA Report, in discussing the industry's technological evolution and oil and gas companies' ability to report proved reserves more accurately than in the past, stated,

> Over the past quarter century, many evolutionary and even revolutionary developments have improved the quality and accuracy of the tools available in 1978, and new and alternative methods of characterizing reservoired hydrocarbon volumes have emerged. When used in combination, these methods can provide reserves estimates that are better founded, or more "reasonably certain," than was possible at the time disclosure guidelines were put in place. Many firms use an integrated combination of these methods to inform critical investment decisions. However, under the current disclosure guidelines, the reserves estimates generated using these methods cannot be disclosed to the investing public.[72]

2. Staff Reviews Use of Year-end Pricing

Rule 4-10 requires that companies evaluate reserves "under existing economic and operating conditions, i.e., prices and costs as of the date the estimate is made."[73] The Staff Outline states,

> Existing economic and operating conditions are the product prices, operating costs, production methods, recovery techniques, transportation and marketing arrangements, ownership and/or entitlement terms and regulatory requirements that are extant on the effective date of the estimate. An anticipated change in conditions must have reasonable certainty of occurrence; the corresponding investment and operating expense to make that change must be included in the economic feasibility at the appropriate time.

Neither the Rule nor the Staff Outline specifically refer to "year-end prices." The CorpFin Staff have taken the position that oil and gas companies must use the year-end oil price, the price on the last day of the year on which the oil markets are open, in reporting proved reserves.

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[71] Letter from ExxonMobil (May 24, 2004), *supra* note 30, at SEC03960, SEC03972.

[72] 2005 CERA Report, *supra* note 33, at 74.

[73] Rule 4-10(a)(2).

Some oil and gas companies, on the other hand, base reserves disclosure upon "planning premises" rather than a year-end spot price. This was in part due to their experiences during the oil price collapse of 1998 and earlier occasions and in part due to the fact that such long-term prices are what oil and gas companies actually use in evaluating and making major capital investment decisions for projects that can take years to build and decades to produce.

a. SEC Staff Instructed ExxonMobil To Discard Planning Prices; ExxonMobil Acquiesced But Viewed Planning Prices as Consistent With Rule 4-10 and Year-End Prices Mis-Inform Investors

In a July 2004 letter to ExxonMobil, the CorpFin Staff stated,

> 5. We cannot agree with the use of "planning prices"—in lieu of year-end pricing—to determine your disclosed proved oil and gas reserves. In part, your response 13 states, "We believe that . . . revising proved reserve estimates to reflect December 31 prices, is not prescribed by SFAS 69 or Regulation S-X, Rule 4-10". [Rule 4-10 requires "existing economic and operating conditions", SFAS 69 ¶ 30a) states "Future cash inflows . . . shall be computed by applying year-end prices relating to the enterprise's proved reserves to the year-end quantities of those reserves."][74] These are all clear guidance that only the price at year-end—the date of the estimate—is appropriate.
>
> . . .
>
> a) Amend your document to incorporate year-end pricing into your proved reserve estimates for all your geographic areas. Disclose these prices for each of your areas.
>
> b) Tell us the planning prices you have used for the years 1994-2003 and your justification for the particular figures you used. . . .[75]

ExxonMobil responded to the SEC's insistence that it comply with the CorpFin Staff's views about year-end prices in an October 2004 letter. In addition to providing a chart that indicated that the year-end price issue would have affected ExxonMobil's total proved oil and gas reserves by a factor ranging from -5.5% in 1998 to +1.9% in 2002, ExxonMobil noted:

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[74] The CorpFin Staff is stretching to require compliance with the Staff Outline. It is not clear whether the language cited in SFAS 69 relates to defining proved reserves themselves or, rather, discusses a method of computing a standardized measure of discounted future cash flows from the proved reserves.

[75] Letter from H. Roger Schwall, Assistant Director, to Donald D. Humphreys, Vice President and Controller, ExxonMobil (July 2, 2004), Exhibit 38, at SEC00494 (directing questions regarding engineering comments to Ronald Winfrey, Petroleum Engineer).

> We continue to believe that the use of the year-end prices for reserve calculations is not prescribed by SFAS 69 and that doing so is inconsistent with Regulation S-X's requirement that reserves should be based on prices at the time the estimate is made. ExxonMobil continues to be concerned about mis-information and possible confusion within the investment community and with shareholders should year-end prices be considered in any evaluation of the company's performance. The basis for this concern is highlighted by looking just at the years 1998 and 1999 during which year-end prices for Brent crude ranged from $10.75 at year-end 1998 to $24.54 by year-end 1999. . . .
>
> . . .
>
> We do not believe these types of variations in the reported amounts of proved reserves are consistent with the principles of SFAS 69 or the intent of the Financial Accounting Standards Board. Further, we believe the reserves estimates reported by ExxonMobil in the past were in full compliance with applicable standards as widely interpreted y the industry. We reiterate our suggestion that the SEC convene appropriate joint government/industry technical groups to address this issue. Consistent with our obligations to provide full, transparent and not misleading disclosure, we will be clear in our future communications that year-end pricing is not relevant in our investment decisions and that annual variations in reserves based on year-end prices and costs are not of consequence in how the business is managed.[76]

b. Chevron Acquiesced to SEC Staff Order to Use Year-End Prices; Noted That Prior Methodology Complied With Rule 4-10 and Year-End Prices Distort Proved Reserves

Chevron addressed year-end pricing in a September 2004 response to the CorpFin Staff's comments:

> Response: The year-end prices that were used for the company's standardized-measure calculation were not the same prices that were associated with the end-of-year reserve quantities. For reserves estimation, the company did not use actual prices at the end of the year. Instead, the company employed a combination of actual prices during the year and prices that were used for calculating project economics and preparing business plans. In combination, the company considered these prices reflective of "existing economic and operating conditions" (referenced in Rule 4-10 of Regulation S-X). As part of its year-end process, the company did perform a review to ensure that recorded reserves were not uneconomic at year-end prices.

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[76] Letter from Patrick T. Mulva, Vice President and Controller, ExxonMobil, to H. Roger Schwall, Assistant Director (Oct. 26, 2004), Exhibit 39, at SEC04009, SEC04010.

> The company infers from the Staff's comment above that year-end prices should be used for reserve computations. Accordingly, the company will confirm to this methodology at the end of 2004. The company will note this pricing methodology in its Form 10-K and describe the effect on reserve quantities if prices are particularly volatile at the end of 2004 (or in future years).[77]

c. Entire Industry Believes SEC Staff Wrong to Insist on Year-End Prices

The CERA Report discussed "the SEC's interpretative guidance that the prices in force on the last day of a company's financial year should be used" and stated,

> This latter requirement illustrates how an interpretation that may have been appropriate when the rules were put in place—an era of regulated natural gas prices (without seasonality in prices) and price controls for domestically produced oil—can be overtaken by reality. Oil has become a volatile, widely traded commodity, the price of which can vary significantly on any particular day. . . . The arbitrary choice of a price on one particular day seems at odds with the longer-term nature of the development and production cycle for oil and gas reserves. . . . All participants agreed that year-end pricing was inappropriate (for both calculating the volumes of proved reserves and the Standardized Measure [known as SMOG]). . .[78]

Oil and gas industry experts do not agree with the CorpFin Staff that Rule 4-10 requires the use of year-end prices. The SEC Staff put pressure on companies to follow their interpretation. Companies complied, but some under protest and noting the distorting effect that the Staff's interpretation would have on proved reserves. The industry in any event has proposed scrapping such an arbitrary standard in favor of one that better represents economic reality and the criteria on which the companies themselves base their investment decisions.[79]

3. SEC Staff Requires Evidence of Project Commitment

A key point in booking a project's proved reserves is, in Shell terms, the Final Investment Decision ("FID") for a project, although proved reserves were booked before, at, and after FID based on a project's "reasonable certainty" as required by Rule 4-10. The SEC Order criticized Shell's proved reserves guidelines for not requiring FID prior to booking proved reserves for a project and found that Shell's fraud violations in part arose from this failure.[80] Other companies

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[77] Letter from John S. Watson, Vice President and Chief Financial Officer, Chevron, to H. Roger Schwall, Assistant Director (Sep. 20, 2004), Exhibit 40, at SEC02941.

[78] 2005 CERA Report, *supra* note 33, at 94.

[79] *See* CERA, Modernizing Oil and Gas Reserves Disclosures (Feb. 2006), Exhibit 41 ("2006 CERA Report").

[80] SEC Order, *supra* note 25, at 7, 9.

described processes that appear to be in some respects different from and in other respects similar to Shell's in response to SEC comment letters. The Staff did not find such processes deficient.

a. Chevron Told the SEC Staff It Booked When "Reasonably Certain" That Development Plan Will Be Approved by Venture Partners

In February 2003, Chevron was asked by the CorpFin Staff about how it booked proved reserves in the deepwater Gulf of Mexico when it is the non-operator of a project. Chevron responded:

> Response: For non-operated properties, we do not report reserves as proved without the geological and reservoir data ChevronTexaco requires. We have and will sanction projects before proved reserves are assigned to the project. However, proved reserves are reported when we have approval of a development plan for the property, or are reasonably certain that approval will be obtained in the near term, and a partners' funding commitment for the plan based on the terms of the property's operating agreements. While we cannot comment on the partners' actual internal budgeting process in support of their funding commitment, ChevronTexaco budgets on an annual basis. When the project development plan extends over more than one year, the company includes its share of the plans' forecasted expenditures in the annual budgets for the specific years in which the expenditures are expected to be made.[81]

b. ConocoPhillips Described Its Policy Considerations In Determining Project Commitment

In April 2004, the CorpFin Staff wrote to ConcoPhillips and commented:

> 28. As you produce oil and gas from many different countries, please explain to us, in as much detail as needed, the processes and controls that you have in place to assure that your reported reserves comply with the SEC definitions as found in Rule 4-10(a) of Regulation S-X.[82]

In its response to the Staff, ConocPhillips documented its approach to project commitment:

> We have a companywide internal policy requiring that technical, commercial, and economic criteria established be satisfied before proved reserves can be added. The

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[81] Letter from John S. Watson, Vice President and Chief Financial Officer, Chevron, to H. Roger Schwall, Assistant Director (Feb. 25, 2003), Exhibit 42, at SEC02754.

[82] Letter from H. Roger Schwall, Assistant Director, to John A. Carrig, Executive Vice President, Finance, and Chief Financial Officer, ConocoPhillips (Apr. 12, 2004), Exhibit 43, at SEC03192.

> policy requires that corporate commitment and capability to undertake development be demonstrated. For example, management, co-venturer and government approvals of development plans are required for significant projects prior to booking reserves. . . .
>
> . . .
>
> . . . Exceptions to the policy may be requested for topics where internal standards reflect management discretion. A possible example where exception to policy could be considered would be demonstration of corporate commitment to develop. Technical or economic criteria established by SEC are not subject to management exception. Requests for exception are reviewed and approved by executive management. (Policy is attached as Exhibit 3).[83]

Based on the produced correspondence, the SEC Staff does not appear to have followed up on ConocoPhillips' description of project commitment required to book proved reserves.

c. ExxonMobil Described to SEC Staff "Reasonable Certainty" and Commitment to Invest in Developing Reserves

In its May 2004 correspondence with the SEC, ExxonMobil spoke about how the company's views on project commitment fit in with the concept of "reasonable certainty":

- The principle of "reasonable certainty" embodied in Regulation S-X drives both our booking process and the results produced thereby. . . .

- Our approach to booking proved reserves is entirely consistent with how we run our business overall. We maintain a long-term conservative, disciplined and consistent approach to all aspects of our business. Booking proved reserves benefits from the same rigorous, science and information-based processes. In short, we do not book reserves unless we have committed to invest in their development, and we are not willing to invest unless we have a high degree of confidence that the reserves will be economically produced over the long term life of the project.

. . .

- . . . In our case, we are only willing to make significant funding commitments on a project if we believe there is a high probability of securing any necessary government

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[83] Letter from ConocoPhillips (Apr. 23, 2004), *supra* note 49, at SEC03221. The letter from ConocoPhillips produced by the Staff did not include the letter's exhibits.

approvals. We believe this approach is consistent with the principle and meets the standard of "reasonable certainty".[84]

The SEC Staff knew before the SEC Order in August 2004 that reputable companies booked reserves for projects on the basis of "reasonable certainty" rather than some artificial budgeting procedure that, in any case, varies from company to company.

4. SEC Staff Requires Production Flow Testing Prior to Booking Proved Reserves

The Staff Outline included the passage:

> Proved reserves may be attributed to a prospective zone if a conclusive formation test has been performed or if there is production from the zone at economic rates. It is clear to the SEC staff that wireline recovery of small volumes (e.g. 100 cc) or production of a few hundred barrels per day in remote locations is not necessarily conclusive.[85]

The CorpFin Staff sent a letter dated October 1, 2002 to major oil and gas companies with interests in the Gulf of Mexico regarding this issue. A selection of the company responses are discussed below.

a. ExxonMobil Told SEC Staff It Booked Proved Reserves Prior to Production Flow Tests

ExxonMobil replied to the Staff inquiries as follows:

1. In a discovery situation, have you booked proved reserves prior to a production flow test in the Gulf of Mexico?

   > Yes, during the 5 year period 1997-2001 (consistent with Question 6) ExxonMobil has booked proved reserves in seven Gulf of Mexico fields prior to a production flow test after making the commercial decision to develop the reserves. The development decision is based on accepted engineering and geoscience principles as explained in the answer to Question 4 [consisting of a list of technical data requirements].

   Have you booked proved reserves without a production flow test in a discovery situation in other areas? Which areas?

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[84] Letter from ExxonMobil (May 24, 2004), *supra* note 30, at SEC03959, SEC03960.

[85] Staff Outline, ¶ II.F.3.(b).

Yes, during the same 5 year period 1997-2001, ExxonMobil has booked proved reserves in three offshore fields in the United Kingdom prior to a production flow test after making the commercial decision to develop as above.[86]

b. Eni Told SEC Staff It Booked Prior to Production Flow Test

Eni responded as follows:

1) In a discovery situation in the GOM, we do not generally consider it necessary to flow test if all the conditions in point 4 below [an array of technical data requirements] have been met. In all cases, proved reserves are not booked prior to Project Sanction and substantial development spending.[87]

c. BP Told SEC Staff It Booked Proved Reserves Without Production Flow Tests

BP's response was similar:

1. In a discovery situation, have you booked proved reserves prior to a production flow test in the Gulf of Mexico? Have you booked proved reserves without a production flow test in a discovery situation in other areas? Which areas?

As shown in Table 1, in the deepwater Gulf of Mexico we are participating in 23 developments, of which 12 are operated by BP and we expect 19 to be on production by the end of 2002. In 17 of these developments, we have booked proved reserves without requiring a prior production flow test (drill stem test).

In some parts of the UK, notably the Southern North Sea, we will generally not conduct flow tests on small (1-3 well) satellite developments where whole core data and/or log data indicate that the reservoirs are analogous to similar reservoirs in nearby fields which are producing. In the UK, there are 6 such fields, three of them operated and all either on production or anticipated to be so by the end of 2002.[88]

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[86] Letter from Richard J. Eichner, Corporate Financial Reporting Manager, and Richard H. Stock, Corporate Accounting Policy Manager, ExxonMobil, to H. Roger Schwall, Assistant Director (Oct. 21, 2002), Exhibit 44, at SEC03842.

[87] Letter from Marco Mangiagalli, Chief Financial Officer, Eni, to H. Roger Schwall, Assistant Director (Oct. 21, 2002), Exhibit 45, at SEC03726.

[88] Letter from Ian Vann, Group Vice-President and Technical Director, BP, to H. Roger Schwall, Assistant Director (Oct. 28, 2002), Exhibit 46, at SEC02159 (copying Ronald M. Winfrey, Petroleum Engineer).

For many years prior to and after the SEC Staff Outline, reputable companies booked proved reserves on the basis of "available geological and engineering data" as stated in Rule 4-10, and disagreed with the newly promulgated interpretation of the SEC Staff that a production flow test was a requirement notwithstanding industry practice based on all available technology.

The SEC, in a letter dated April 15, 2004 from Mr. Schwall, relaxed the requirement for a production flow test in the Gulf of Mexico—but not for the rest of the world.

5. Rule 4-10(a)(4) and "certainty that there is continuity of production"

The Staff Outline drew attention to Rule 4-10(a)(4)'s definition of proved undeveloped reserves ("PUDs") and specifically to the attribution of PUDs in locations offset from productive units. The definition in Rule 4-10 states:

> Proved undeveloped oil and gas reserves are reserves that are expected to be recovered from new wells on undrilled acreage, or from existing wells where a relatively major expenditure is required for recompletion. Reserves on undrilled acreage shall be limited to those drilling units offsetting productive units that are reasonably certain of production when drilled. Proved reserves for other undrilled units can be claimed only where it can be demonstrated with certainty that there is continuity of production from the existing productive formation. . . .

The Staff Outline underlined the words "certainty" and "continuity of production" and stated:

> The SEC staff points out that this definition contains no mitigating modifier for the word certainty. Also, continuity of production requires more than the technical indication of favorable structure alone (e.g. seismic data) to meet the test for proved undeveloped reserves. Generally, proved undeveloped reserves can be claimed only for legal and technically justified drainage areas offsetting an existing productive well (but structurally no lower than LKH. If there are at least two wells in the same reservoir which are separated by more than one legal location and which show communication (reservoir continuity), proved undeveloped reserves could be claimed between the two wells, even though the location in question might be more than an offset well location away from any of the wells. . . . The SEC staff emphasizes that proved reserves cannot be claimed more than one offset location away from a productive well if there are no other wells in the reservoir, even though seismic data may exist. . . . seismic data is not an indicator of continuity of production and, therefore, can not be the sole indicator of additional proved reserves beyond the legal and technically justified drainage areas of wells that were drilled. . . .[89]

[89] Staff Outline, ¶ II.F.3.(f).

a. BP Told SEC Staff It Booked PUDs Outside US and Canada Based on "Best Technical Judgment" of Continuity of Production

The CorpFin Staff sent a letter to major oil and gas companies asking a "boiler plate" question about PUDs:

> g) Rule 4-10(a)(4) of Regulation S-X provides that proved undeveloped oil and gas reserves may be attributed to locations not offsetting productive units only "where it can be demonstrated with certainty that there is continuity of production from the existing productive formation (emphasis added)." Supplementally, submit to us a description of the engineering and geologic justification for any PUD reserves you have claimed which is not in legal, technically justified locations offsetting (adjacent to) productive wells. Otherwise, either affirm to us that none of your claimed PUD reserves are attributed to such locations or delete such volumes from your disclosed proved reserves.[90]

Examples of responses are given below.

BP responded on January 12, 2004:

> (g) In the Onshore lower 48 and Canada, the terminology "legal locations" with a regulatory body specifying well spacing for field development applies. In these areas, total proved undeveloped reserves at end 2002 are less than 10% of total proved reserves, and we affirm that none of these volumes lie in acreage which is more than one location offset from productive units.
>
> In all other areas it is BP's practice to use our best technical judgment to determine where it can be demonstrated with certainty that there is continuity of production. . . .
>
> The engineering and geologic justification for PUD reserves is based on a combination of the following approaches which are generally applied. The combination depends on the reservoir in question: [list of technical criteria]
>
> . . .
>
> We respectfully refer to the presentation to the Staff's petroleum engineers on the Horn Mountain field made by our subsurface technical staff in Houston at the BP

[90] *E.g.*, Letter to BP (Dec. 9, 2003), *supra* note 34, at SEC00564 (alterations in original).

> HIVE on October 27, 2003 which demonstrated how we apply these engineering and geologic approaches.[91]

The CorpFin Staff commented on BP's response:

> 48. Your response 34(g) to our letter dated December 9, 2003 indicates that you have claimed proved undeveloped reserves for locations that were not adjacent to productive wells. The statistics for your 2002 development drilling is an example of sampling without replacement and cannot necessarily be relied upon as assurance of future performance. Generally, we have not accepted support for the certainty of "continuity of production" without compelling evidence of pressure communication. Affirm to us that, in future documents, you will claim only:
>
> a) PUD reserves attributed to technically and legally justified locations that are adjacent to productive wells;
>
> b) Those volumes as proved reserves that are above the lowest known oil or below highest known gas as determined by well penetration and assessment.[92]

BP's response was provided in a letter dated March 31, 2004. However, BP requested confidential treatment of certain of its responses, including responses to this Staff comment, and the SEC has failed to produce these communications.[93]

b. ExxonMobil Told SEC Staff It Booked PUDs More Than One Offset From Producing Wells in Compliance With Rule 4-10

ExxonMobil responded to the CorpFin Staff's comment letter on February 13, 2004:

> Exxon Mobil's proved reserves are consistent with the statement from Rule 4-10(a)(2) of Regulation S-X which provides that "Proved oil and gas reserves are 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." We believe the key words in Rule 4-10(a)(2) are that proved reserves are estimates that are reasonably certain to be recoverable. These words are inconsistent with the words "certainty that there is continuity of

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[91] Letter from BP (Jan. 12, 2004), *supra* note 48, at SEC02249-51. As noted above and in the April 28 letter, Watts has subpoenaed the SEC for all communications regarding Rule 4-10 between the SEC and members of the oil and gas industry, including BP. BP's October 27, 2003 presentation has not been produced to date.

[92] Letter to BP (Feb. 13, 2004), *supra* note 36, at SEC00579.

[93] Letter from BP (Mar. 31, 2004), *supra* note 55, at SEC02275, SEC02279 (comment 32).

production" which are underlined in comment 80. We believe that in the subsurface, certainty is relative, not absolute and hence we use "reasonable certainty" in all our proved reserves estimates. In our opinion, this is a broader industry issues that should be the subject of dialogue between industry groups such as the Society of Petroleum Engineers and the Securities and Exchange Commission technical staff. Our estimates of proved reserves are reasonably certain of recovery based on all the engineering and geologic data and our performance experience on some 2700 fields in our portfolio. Volumes carried for fields in the proved undeveloped category are reviewed and updated on a regular basis as fields are developed and additional data and production performance dictates. The reserves review process is structured and rigorous in both the addition and reduction of reserves. The majority of our revisions are positive, reflecting technical support of our initial estimates and conformance with "reasonable certainty."[94]

The CorpFin Staff did not agree with ExxonMobil's position and, in a letter dated March 29, 2004, commented:

14. We do not concur with your analysis regarding Rule 4-10(1)(4) and reiterate prior comment 80. Supplementally:

a) Furnish us with a listing – including field name and claimed proved reserves – of all properties to which you have attributed such PUD reserves in the prior three years;

. . .

We take your statement that this issue should be discussed among industry groups under advisement.[95]

Exxon Mobil replied on May 24, 2004:

The following table lists the fields which were determined to have PUD reserves booked outside one offset spacing unity in any of the years 2001 through 2003.

	Proved Undeveloped Reserves Booked Outside Offset Spacing (EMNI MBOE)		
Field Name*	**2001**	**2002**	**2003**
Groningen (The Netherlands)	**	**	**

[94] Letter from ExxonMobil (Feb. 13, 2004), *supra* note 29, at SEC03920 (emphasis in original).

[95] Letter to ExxonMobil (Mar. 29, 2004), *supra* note 44, at SEC00487.

Megastructure (Azerbijan)	47	102	104
Grane (Norway)	71	48	48
Barracouta (Australia)	24	24	24
Dalia (Angola)	0	23	23
Miandoum (Chad)	20	13	0
Zuni (US)	12	10	4
Thunder Horse North (US)	15	3	2
Diana (US)	2	2	2
Hibernia (Canada)	1	1	1
Mobile Bay (US)	1	1	1
Angsi (Malaysia)	10	1	0
Bolobo (Chad)	1	1	0
Seligi (Malaysia)	<0.5	<0.5	<0.5
Tapis (Malaysia)	<0.5	<0.5	1
Kome (Chad)	44	0	0
Orion (US)	0	0	6

Despite being outside of the offset guideline as we understand it to be applied by the SEC staff, we believe these reserves to have been properly booked in accordance with Regulation S-X.

* Due to the large number of fields in ExxonMobil's portfolio, only those which were considered significant (within top 90% of ExxonMobil's PUD reserves base) were investigated.

** See Groningen information below.[96]

The CorpFin Staff did not inquire further as to ExxonMobil's PUDs outside one offset spacing from producing wells.

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[96] Letter from ExxonMobil (May 24, 2004), *supra* note 30, at SEC03975-76. With regard to Groningen, ExxonMobil explained:

> There is no prescribed well spacing in the Netherlands. The field has been developed with 26 cluster well locations. If clusters are considered drilling units, no PUD reserves are attributed outside offset locations. In the most extreme interpretation, if individual wells are considered drilling units, in 2002 there were approximately 461 MBOE of PUD reserves outside of a single well spacing. No future wells are required, however, to produce the proved reserves.

Id., at SEC03976 (emphasis in original).

V. Shift from "Reasonable Certainty" to "Absolute Certainty"

CERA says that reserves estimation should be a process of continual learning but asserts that the SEC's "1978 system has become increasingly rigid and adversarial."[97] As discussed above, the Staff's directives in the comment letters lend support to this view. Additionally, during public forums with oil and gas industry experts,

> petroleum engineers Ronald Winfrey and James Murphy have bluntly argued . . . that the industry's reliance on new technologies had caused many reserve write-downs over the past few years. "Prove it to us or take it out," Mr. Murphy barked at a Society of Petroleum Evaluation Engineers Forum in October. "Investors do not believe the reserve numbers anyway," he added.[98]

As noted in the CERA Report, the SEC

> appears to have shifted from "reasonable certainty" further toward "absolute certainty" and, in so doing, has transformed a principle-based reporting system to a rule-based one, without the kind of transparency and discussion that the SEC utilizes for other kinds of rule making.[99]

In discussing the Staff position, CERA said,

> Both companies and the SEC began to treat the outcome of their clarification discussions as if they were rules—provided that a company consistently applied the agreed approach, this would support a presumption that their reserves met the test of 'reasonable certainty' in a move toward a more mechanical approach to compliance. However, these new 'rules' did not benefit from prior consultation with the industry at large and applied to particular situations. This increased the likelihood that they would not be sufficiently broad to cover a wider range of situations.[100]

Because the SEC has failed to provide constructive, expert guidance to the oil and gas industry in the area of proved oil and gas reserves definitions, the industry has responded by proposing that the SEC give way to the experts. In a follow-up report, CERA has proposed that the SEC abandon the outdated application of Rule 4-10's standards as embodied in the Staff Outline. CERA suggests instead that the SEC adopt the SPE's definitions, which are in line with industry practice and reflect the factors oil and gas companies actually employ in evaluating their reserves

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[97] 2005 CERA Report, *supra* note 33, at 8.

[98] Schroeder, *supra* note 3.

[99] 2005 CERA Report, *supra* note 33, at 15.

[100] *Id.*, at 22-23.

and making investment decisions.[101] CERA proposes a regime similar to that followed by the accounting industry, with industry experts setting the standards (similar to the Financial Accounting Standards Board) and the SEC ensuring that registrants adhere to the established industry standards.

VI. SEC Order Against Shell Improperly Based Upon Staff Outline

As discussed above, Shell was charged with fraud for what many in the industry thought were correct interpretations of Rule 4-10. This section briefly identifies several by way of example.

A. Government and Regulatory Approvals

The SEC Order found that,

> Despite explicit staff guidance in 2000 and 2001 that reserves subject to significant government and regulatory approvals (e.g., production license extensions) required "a long and clear track record which supports the conclusion that such approvals and renewal are a matter of course," Shell's guidelines through 2002 failed to require sufficient assurance of such approvals and, as a result, Shell booked proved reserves for certain projects for which governmental or regulatory approvals were not sufficiently assured for there to be "reasonable certainty" of the recovery of those reserves in future years. These deficiencies impacted reserves bookings in Kazakhstan (Kashagan field) . . . .[102]

Rule 4-10 is silent on the subject of government and regulatory approvals. Rule 4-10 requires that such approvals be "reasonably certain" but does not set forth a requirement that "reasonable certainty" can only be satisfied by "a long and clear track record which supports . . . those approvals and renewal [as] a matter of course."

Shell was not alone in booking Kashagan reserves. As the SEC knew, prior to the issuance of the SEC Order, the reserves experts at ExxonMobil and Total had done the same. Other companies made different judgments. None but Shell was charged with fraud.

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[101] *See* 2006 CERA Report, *supra* note 79.

[102] SEC Order, *supra* note 25, at 7.

B. Gas Contracts and Final Investment Decisions

The SEC Order stated that Shell's booking of proved reserves in relation to the Gorgon gas fields violated Rule 4-10 because

> Shell did not have a contract to sell Gorgon gas, had no firm development plan and had not made a Final Investment Decision.[103]

Rule 4-10 does not require that there have to be contracts to sell gas, firm development plans, or final investment decision in place to establish reasonable certainty for booking proved reserves. Many companies besides Shell made similar judgments on these issues and the SEC has not charged these companies with fraud.

C. License Expiry

The SEC Order found that Shell committee fraud when it learned that some of its proved reserves in SPDC Nigeria would be produced beyond the expiration of current production licenses and Shell "failed to recommend any de-bookings to address the license expiration issues."[104]

Rule 4-10 does not require proved reserves booked beyond license expiry to be de-booked if a company is "reasonably certain" that license extensions will be obtained so that the proved reserves will be produced. This was the decision Shell made with respect to SPDC Nigeria. As the SEC Staff knew when it drafted the SEC Order against Shell, many other major oil and gas companies made similar decisions in such situations as Shell. None of these other companies has been charged with fraud.

D. Technical Requirements

The SEC Order stated that Shell's proved reserves guidelines failed in several respects to comply with the technical engineering standards embodied in Rule 4-10:

> These technical requirements include both restrictions on estimates of the depth and lateral extent of reserves – known in the engineering field as "lowest known hydrocarbon" and "lateral extent of proved area" requirements – as well as standards governing the use of year-end prices, . . .[105]

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[103] *Id.*, at 9-10.

[104] *Id.*, at 11.

[105] *Id.*, at 7.

As discussed above, reputable companies took exception to the SEC Staff interpretations of these issues and maintained that the Staff's views were not what was required by Rule 4-10. These companies have not been accused of fraud.

VII. Conclusion

Each of the issues that contributed to Shell's recategorization of proved reserves were common to other major oil and gas industry registrants, such as formal government approvals, gas contracts/robust gas markets, license renewal, LKH, and year-end pricing. None of the key reserves issues cited as violations in the SEC Order was unique to Shell. The SEC Order against Shell is based on the Staff Outline, not Rule 4-10.

Documents produced by the Office of the General Counsel confirm what Watts has maintained in his previous submissions to the SEC.

During Project Rockford, Shell retrospectively applied its tightened October 2003 Shell Reserves Guidelines to all prior bookings. The revised guidelines were the product of three successive revisions of the guidelines by Shell's petroleum engineering staff with review by Shell's external auditors. The successive revisions represented Shell's experts' best efforts to comply with their understanding of the SEC Staff Outline. Whether or not the Staff Outline was enforceable, Shell's experts attempted to comply with it as if it were.

Shell originally intended to make the recategorization a current-period revision because it was triggered by new information concerning project maturity from Nigeria and Oman learned during 2003. However, the CorpFin Staff insisted that Shell needed to restate earlier period filings while knowing that the other major oil and gas companies had also booked proved reserves in similar circumstances as Shell. As an SEC filer, the company carried out the restatement as dictated by the CorpFin Staff.

Recent evidence that has come to light confirms Watts' position regarding the effect of the CorpFin Staff's actions on Shell and the oil and gas industry. As additional evidence is obtained, the SEC's burden will become more difficult to maintain and Watts' case will continue to strengthen.

We respectfully suggest that the SEC Staff end its investigation and recommend that no enforcement action be taken against Watts, a decision already taken by the United Kingdom's Financial Services Authority ("FSA") based on the same facts developed in the joint SEC/FSA investigation.

In the event that the Staff determines that it will make a recommendation to the Commission for an enforcement action against Watts, please forward to the Commission a copy of this letter and enclosures in addition to Watts' previous submissions.

* * *

Sincerely,

Joseph I. Goldstein

Enclosures

cc: Linda C. Thomsen, Esq.
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