

capitalized costs, net of accumulated depreciation and amortization, and deferred income taxes, should not exceed an amount equal to the sum of [components that include] the present value of estimated future net revenues computed by applying current prices of oil and gas reserves (with consideration of price changes only to the extent provided by contractual arrangements) to estimated future production of proved oil and gas reserves as of the date of the latest balance sheet presented.

As of the reported balance sheet date, capitalized costs of an oil and gas producing company exceed the full cost limitation calculated under the above described rule based on current spot market prices for oil and natural gas. However, prior to the balance sheet date, the company enters into certain hedging arrangements for a portion of its future natural gas and oil production, thereby enabling the company to receive future cash flows that are higher than the estimated future cash flows indicated by use of the spot market price as of the reported balance sheet date. These arrangements qualify as cash flow hedges under the provisions of Statement 133 as amended and interpreted, and are documented, designated, and accounted for as such under the criteria of that standard.

Question: Under these circumstances, must the company use the higher prices to be received after taking into account the hedging arrangements ("hedge-adjusted prices") in calculating the current price of the quantities of its future production of oil and gas reserves covered by the hedges as of the reported balance sheet date?

Interpretive Response: Yes. Derivative contracts that qualify as hedging instruments in a cash flow hedge and are accounted for as such pursuant to Statement 133 represent the type of contractual arrangements for which consideration of price changes should be given under the existing rule. While the SEC staff has objected to previous proposals to consider various hedging techniques as being equivalent to the contractual arrangements permitted under the existing rules, the staff's objection was based on concerns that the lack of clear, consistent guidance in the accounting literature would lead to inconsistent application in practice. For example, prior to the adoption of Statement 133, hedging activities related to foreign exchange rates were addressed in Statement 52. The use of futures contracts as hedging arrangements was previously addressed in Statement 80. The guidance provided in these Statements differed from

Statement 133 in the criteria used to qualify for hedge accounting. However, the staff believes that Statement 133 and related guidance (including a more systematic approach to documentation) provides sufficient guidance so that comparable financial reporting in comparable factual circumstances should result.

This interpretive response reflects the SEC staff's view that, assuming compliance with the prerequisite accounting requirements, hedge-adjusted prices represent the best measure of estimated cash flows from future production of the affected oil and gas reserves to use in calculating the ceiling limitation. Nonetheless, the staff expects that oil and gas producing companies subject to the full cost rules will clearly indicate the effects of using cash flow hedges in calculating ceiling limitations within their financial statement footnotes. The staff further expects that disclosures will indicate the portion of future oil and gas production being hedged. The dollar amount that would have been charged to income had the effects of the cash flow hedges not been considered in calculating the ceiling limitation also should be disclosed.

The use of hedge-adjusted prices should be consistently applied in all reporting periods, including periods in which the hedge-adjusted price is less than the current spot market price. Oil and gas producers whose computation of the ceiling limitation includes hedge-adjusted prices because of the use of cash flow hedges also should consider the disclosure requirements under the SOP 94-6. Paragraph 14 of SOP 94-6 calls for disclosure when it is at least reasonably possible that the effects of cash flow hedges on capitalized costs on the reported balance sheet date will change in the near term due to one or more confirming events, such as potential future changes in commodity prices.

In addition, the use of cash flow hedges in calculating the ceiling limitation may represent a type of critical accounting policy that oil and gas producers should consider disclosing consistent with the cautionary advice provided in FR 60. Through this release, the Commission has encouraged companies to include, within their MD&A disclosures, full explanations, in plain English, of the judgments and uncertainties affecting the application of critical accounting policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions.

The staff's guidance on this issue would apply to calculations of ceiling limitations both in interim and annual periods.

c. Effect of subsequent events on the computation of the limitation on capitalized costs

Facts: Rule 4-10(c)(4)(ii) of Regulation S-X provides that an excess of unamortized capitalized costs within a cost center over the related cost ceiling shall be charged to expense in the period the excess occurs.

Question: Assume that at the date of company's fiscal year-end, its capitalized costs of oil and gas producing properties exceed the limitation prescribed by Rule 4-10(c)(4) of Regulation S-X. Thus, a write down is indicated. Subsequent to year-end but before the date of the auditors' report on the company's financial statements, assume that one of two events occurs: (1) additional reserves are proved up on properties owned at year-end, or (2) price increases become known which were not fixed and determinable at year-end. The present value of future net revenues from the additional reserves or from the increased prices is sufficiently large that if the full cost ceiling limitation were recomputed giving effect to those factors as of year-end, the ceiling would more than cover the costs. It is necessary to record a write down?

Interpretive Response: No. In these cases, the proving up of additional reserves on properties owned at year-end or the increase in prices indicates that the capitalized costs were not in fact impaired at year-end. However, for purposes of the revised computation of the "ceiling," the net book costs capitalized as of year-end should be increased by the amount of any additional costs incurred subsequent to year-end to prove the additional reserves or by any related costs previously excluded from amortization.

While the fact pattern described herein relates to annual periods, the guidance on the effects of subsequent events applies equally to interim period calculations of the ceiling limitation. However, the staff cautions registrants that the process of considering subsequent price changes in the determination of whether a ceiling write-down is called for should be similar to the consideration given to other subsequent events under the auditing literature. The staff expects that the date selected for the ceiling recomputation will be consistent from period to period, and bear a logical relationship to the filing date of the affected financial statements. For example, it would seem logical that an oil and gas producing company would