

consistently make whatever recalculations are necessary at the date the auditors are completing their interim reviews.

The registrant's financial statements should disclose that capitalized costs exceeded the limitation thereon at year-end and should explain why the excess was not charged against earnings. In addition, the registrant's supplemental disclosures of estimated proved reserve quantities and related future net revenues and costs should not give effect to the reserves proved up or the cost incurred after year-end or to the price increases occurring after year-end. However, such quantities and amounts may be disclosed separately, with appropriate explanations.

Registrants should be aware that oil and gas reserves related to properties acquired after year-end would not justify avoiding a write-off indicated as of year-end. Similarly, the effects of cash flow hedging arrangements entered into after year-end cannot be factored into the calculation of the ceiling limitation at year-end. Such acquisitions and financial arrangements do not confirm situations existing at year-end.

E. Financial Statements of Royalty Trusts

Facts: Several oil and gas exploration and production companies have created "royalty trusts." Typically, the creating company conveys a net profits interest in certain of its oil and gas properties to the newly created trust and then distributes units in the trust to its shareholders. The trust is a passive entity which is prohibited from entering into or engaging in any business or commercial activity of any kind and from acquiring any oil and gas lease, royalty or other mineral interest. The function of the trust is to serve as an agent to distribute the income from the net profits interest. The amount to be periodically distributed to the unitholders is defined in the trust agreement and is typically determined based on the cash received from the net profits interest less expenses of the trustee. Royalty trusts have typically reported their earnings on the basis of cash distributions to unitholders. The net profits interest paid to the trust for any month is based on production from a preceding month; therefore, the method of accounting followed by the trust for the net profits interest income is different from the creating company's method of accounting for the related revenue.

Question: Will the staff accept a statement of distributable income which reflects the amounts to be distributed for the period in question under the terms

of the trust agreement in lieu of a statement of income prepared under GAAP?

Interpretive Response: Yes. Although financial statements filed with the Commission are normally required to be prepared in accordance with GAAP, the Commission's rules provide that other presentations may be acceptable in unusual situations. Since the operations of a royalty trust are limited to the distribution of income from the net profits interests contributed to it, the staff believes that the item of primary importance to the reader of the financial statements of the royalty trust is the amount of the cash distributions to the unitholders for the period reported. Should there be any change in the nature of the trust's operations due to revisions in the tax laws or other factors, the staff's interpretation would be reexamined.

A note to the financial statements should disclose the method used in determining distributable income and should also describe how distributable income as reported differs from income determined on the basis of GAAP.

F. Gross Revenue Method of Amortizing Capitalized Costs

Facts: Rule 4-10(c)(3)(iii) of Regulation S-X states in part:

Amortization shall be computed on the basis of physical units, with oil and gas converted to a common unit of measure on the basis of their approximate relative energy content, unless economic circumstances (related to the effects of regulated prices) indicate that use of units of revenue is a more appropriate basis of computing amortization. In the latter case, amortization shall be computed on the basis of current gross revenues (excluding royalty payments and net profits disbursements) from production in relation to future gross revenues based on current prices (including consideration of changes in existing prices provided only by contractual arrangements), from estimated production of proved oil and gas reserves.

Question: May entities using the full cost method of accounting for oil and gas producing activities compute amortization based on the gross revenue method described in the above rule when substantial production is not subject to pricing regulation?

Interpretive Response: Yes. Under the existing rules for cost amortization adopted in ASR 258, the use of the gross revenue method of amortization was permitted in those circumstances where, because of the effect of existing pricing regulations, the use of the units of production method would result in an amortization provision that would be inconsistent with the current prices being received. While the effect of regulation on gas prices has lessened,

factors other than price regulation (such as changes in typical contract lengths and methods of marketing natural gas) have caused oil and gas prices to be disproportionate to their relative energy content. The staff therefore believes that it may be more appropriate for registrants to compute amortization based on the gross revenue method whenever oil and gas sales prices are disproportionate to their relative energy content to the extent that the use of the units of production method would result in an improper matching of the costs of oil and gas production against the related revenue received. The method should be consistently applied and appropriately disclosed within the financial statements.

G. Inclusion of Methane Gas in Proved Reserves

Facts: Because of a concern over worldwide oil and gas supplies, Congress, in 1980, provided for tax incentives (credits) for the production of oil and gas from other than conventional sources. As a consequence, significant amounts of gas are now recovered from seams of coal beds. This gas is referred to as coalbed methane. It is produced using conventional drilling methods, but for various reasons, it may be more costly to produce than oil and gas recovered from customary sources and some reserves may not be economical without the tax credits.

Rule 4-10(a)(1)(i)(A) of Regulation S-X indicates that oil and gas producing activities include the search for crude oil, including condensate and natural gas liquids, or natural gas in their natural states and original locations. Rule 4-10(a)(2)(iii)(D) of Regulation S-X states that estimates of proved reserves do not include (among other things) natural gas that can be recovered from coal.¹ In addition, the definition of proved oil and gas reserves includes a provision that the quantities of natural gas be recovered from existing reservoirs. Under these definitions, "coalbed methane" gas has generally not been included in the disclosures in Commission filings required by Statement 69. Further, coalbed methane has generally not been counted in proved oil and gas reserves for purposes of the full cost ceiling test in Rule 4-10(c)(4) since that test is based on the same definition of proved oil and gas reserves.

Question: Is it appropriate to consider coalbed methane gas within the definition of proved reserves for purposes of the disclosures relating to

¹ Similar language appears in Statements 19 and 25.