HMRC - OT02002 - Unique Features Of The Oil And Gas Industry

In the early years of the industry oil and gas exploration and production took place in relatively low cost on shore sites in the USA and the Persian Gulf area, or the shallow water sites off shore, e.g. the Gulf of Mexico. In the last 40 years major reserves have been found and developed in much more hostile environments, including the UK Continental Shelf and Alaska. Activities in these latter environments exhibit several distinctive features:

the costs and risks of exploration are high and increase substantially as exploration moves into areas of deeper water or more extreme weather conditions, and there is often a low probability of discovering commercial reserves in any individual location;

the elapsed time between initial exploration, the assessment of whether commercial reserves exist and the bringing of such reserves, if any, into production may be several years, - in the UK North Sea exploration and development activities have often taken ten years or more, and even then it may take another twenty or thirty years to produce all the recoverable reserves;

there is no necessary correlation between the costs of exploration and development expenditure incurred and the value of the oil and gas reserves discovered as a result of those activities. For example, entities can incur considerable costs and find little, or incur relatively modest costs and discover immense reserves; and

the major economic value which lies within an entity which undertakes exploration and development for oil and gas will often be found in its underlying, i.e. unextracted, oil and gas reserves which are not recorded in company balance sheets, but which are disclosed in a prescribed format - in the UK in quantitative terms. These reserve quantities cannot be measured exactly since their estimation involves some subjective judgement and arbitrary determinations; consequently, reserve disclosures are unaudited.

These and other factors illustrate the complexities of how best to provide a proper accounting presentation of the underlying activities and in particular how best to match costs with revenues.

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