Standard Oil Company of California
225 Bush Street, San Francisco, CA 94104

Audit Committee of the Board of Directors

David Packard, Chairman
Kenneth E. Hill
Carla A. Hills
George H. Weyerhaeuser

April 30, 1979

Mr. Harold M. Williams
Chairman
Securities and Exchange Commission
500 North Capitol Street
Washington, D.C. 20549

Dear Chairman Williams:

The Commission has stressed the vital importance of an independent Audit Committee to oversee the proper functioning of American business corporations and we, the members of the Board Audit Committee of Standard Oil Company of California, commend the support given to this development. It is because of the Commission's strong support for audit committees that we take the unusual step of writing directly to you concerning Reserve Recognition Accounting. This is an issue that has the potential to seriously impair the integrity and meaningfulness of financial reports issued by oil and gas companies.

It seems appropriate to describe our backgrounds so that you can appreciate the broad and diverse viewpoints from which we have addressed this subject. Mr. David Packard, Chairman of the Audit Committee, is Chairman of the Board of Hewlett-Packard, and previously served as U.S. Deputy Secretary of Defense. Mr. George Weyerhaeuser is Chief Executive Officer of Weyerhaeuser Company, which, like oil and gas companies, is involved in a natural resource industry. Mr. Kenneth Hill is particularly knowledgeable about evaluation techniques used for petroleum operations by investment and banking companies as a result of eighteen years experience with Blyth Eastman Dillon & Co., as well as thirteen years previous experience with the Chase Manhattan Bank Petroleum Department. Mrs. Carla Hills, a member of a law firm specializing in securities laws, has an unusual awareness of the importance of accounting and financial reporting from a legal standpoint. Mrs. Hills, who formerly served as Secretary of the U.S. Department of Housing and Urban Development, as well as an Assistant Attorney General in the U.S. Department of Justice, presently serves as a member of the Financial Accounting Standards Board's Advisory Committee.

The central issue is whether Reserve Recognition Accounting will improve the quality and usefulness of petroleum companies' financial reporting for a broad spectrum of interests -- stockholders, government, security analysts, bankers and others. While many details of RRA are vague, it is clear that the fundamental basis for RRA is the estimation of reserves in the ground and the reporting of estimated profits from their future production -- exercises involving highly subjective judgments of many sorts. Different reservoir engineers faced with the same technical data arrive at widely varying professional estimates as to the quantities and producibility of oil or gas reserves. This is especially true in the very early life of newly discovered fields, particularly those with potential for secondary recovery, when estimates may well vary by as much as 50% to 100%. Even in the case of older fields estimates can vary by as much as 10% to 15%. The guesswork inherent in RRA reporting seems almost intended to encourage manipulation of reported profits, since financial effects of actual business transactions in the current year might easily be obscured by revising estimates for future activities.

Most disturbing to us is a possibility that sometime in the future, RRA might be substituted for historical cost accounting in primary financial statements. We do not understand how RRA can be expected to result in improved or more useful reporting of current operations, financial status, or future potentials. A change to substitute non-verifiable estimates of future operations for objectively determined measures of actual operations seems like a step backward.

As corporate directors, each of us knows that accounting and financial reporting should provide the best possible information concerning a company's operation. However, the proposed reporting of "profit" at the time reserves are discovered, which can be many years prior to the actual use of reserves, is a concept alien to us. Such unique profit recognition together with the conjectural orientation of RRA makes us very seriously doubt that RRA would be worthwhile or justifiable on a cost versus benefits basis for any purpose.

It seems clear that profits determined on an RRA basis would be more volatile than either actual cash flow or profits determined on a historical cost basis. You certainly will appreciate that profit volatility generally is equated with higher risk, which in turn requires higher return to investors in the form of lower stock prices. Consequently, we conclude that RRA would tend to reduce price/earnings ratios, resulting in a potential real capitalization loss for the petroleum industry, a loss which our nation can ill afford.

We are especially disturbed by the Commission's haste in moving toward the implementation of what we regard to be a radical, untested and impractical idea. For this reason we urge a reconsideration of the basic RRA idea in the form of a penetrating evaluation of its purpose, practicality and usefulness. This reconsideration should begin by suspending the April 30, 1979 due date for comments concerning the proposed Supplementary Earnings Summary. At the very least this suspension should continue until the Commission's Staff has fully studied the reporting of 1978 reserves values. Astute experimentation with the reserves reported for 1978 should provide an insight into vital problems inherent in the foundation for RRA.

We believe that unconstrained reconsideration of RRA by the Commission can only lead to rescinding the RRA proposals and requirements. The Commission should then turn its attention to identifying one preferable historical cost basis for petroleum accounting. With adequate time and study, it might be possible to devise a new historical cost accounting method which better correlates costs with reserves to permit better matching of the costs with revenues when realized.

We feel it our duty as an Audit Committee to advise the Commission that we consider RRA to be both unjustifiable and undesirable.

Very truly yours,

David Packard

Carla Anderson Hills

Kenneth E. Hill

George H. Weyerhaeuser

cc: Commissioner John R. Evans
Commissioner Roberta S. Karmel
Commissioner Philip A. Loomis, Jr.
Commissioner Irving M. Pollack