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Oil and Gas Reserves Disclosure

SEC Adopts Rules to Modernize Disclosure Requirements for Oil and Gas Reserves

SUMMARY

On December 31, 2008, the SEC released final rules amending the current oil and gas reporting requirements. The new rules are intended to reflect significant changes in the oil and gas industry that have taken place in the three decades since the rules were adopted, including technological advances and changes in the types of projects in which oil and gas companies invest their capital. The SEC has stated that the amendments are designed, among other things, to align disclosure requirements with current industry practices and to provide investors with a more meaningful and comprehensive understanding of reserves.

The most significant changes introduced by the SEC's rule amendments include:

- **Prices used to estimate reserves** for both reserves disclosure and accounting purposes will now be a 12-month average price, based on the first-day-of-the-month price for each month, rather than a single-day, year-end price.
- **Alternative technologies may be used to establish proved reserves** if they satisfy a new principles-based definition of "reliable technology."
- **Reasonable certainty** for the purpose of estimating proved reserves is defined to mean a high degree of confidence or at least a 90% probability that the quantities will be recovered.
- **Non-traditional resources**, such as bitumen extracted from oil sands and oil and gas extracted from coal and shale, may be included in disclosure of oil and gas reserves.
- **Optional disclosure of probable and possible reserves** will be permitted.
- **Conforming changes to Form 20-F** will impose the same oil and gas disclosure requirements on foreign private issuers, resulting in a significant expansion of the required disclosures for non-U.S. oil and gas companies.

The new rules also codify and update the detailed disclosure requirements relating to oil and gas operations, but do not include a mandatory reserves audit requirement, as had been suggested.

The new rules will become effective for registration statements filed on or after January 1, 2010 and for annual reports on Form 10-K and Form 20-F for fiscal years ending on or after December 31, 2009.

BACKGROUND

The SEC adopted its current disclosure requirements for oil and gas reserves in 1978 and 1982. The requirements, which are set forth in Item 102 of Regulation S-K, Item 4 and Appendix A of Form 20-F and Rule 4-10 of Regulation S-X, prohibit issuers from disclosing in SEC filings any oil and gas reserves other than “proved reserves.” Proved reserves are defined to be the estimated quantities of oil and gas which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions. The current definitions specify certain types of data and techniques that may be used to estimate proved reserves. The definitions also expressly exclude hydrocarbons that can be recovered from certain sources such as oil shales and tar sands. Also, under the current definitions, reserves are required to be estimated using a single-day, year-end price.

On December 12, 2007, the SEC published a concept release¹ seeking public comment on possible revisions to the SEC’s disclosure requirements for oil and gas reserves. The Concept Release solicited comments on a number of questions, including whether the SEC should allow disclosure of reserves other than “proved reserves,” whether the revised disclosure rules should be modeled on any particular resource classification framework used within the oil and gas industry, and whether the SEC should require independent third-party assessment of reserve estimates included in company filings. On June 26, 2008, the SEC issued a proposing release² seeking public comment on proposed amendments to the disclosure requirements regarding oil and gas companies. These proposals encompassed issues that had been previously addressed more generally in the Concept Release, but also contained proposals not addressed by the Concept Release related to the updating, codification and expansion of the requirements currently included in Industry Guide 2. The SEC adopted the new rules on December 31, 2008.³

REVISIONS TO DEFINITIONS

The new rules amend and integrate the definitions section in Rule 4-10(a) of Regulation S-X in several significant respects. Although the SEC did not adopt the Petroleum Resource Management System

¹ SEC Concept Release 33-8870; 34-56945; File No. S7-29-07; Concept Release on Possible Revisions to the Disclosure Requirements Relating to Oil and Gas Reserves (the “Concept Release”).

² SEC Release 33-8935; 34-58030; File No. S7-15-08; Modernization of the Oil and Gas Reporting Requirements (the “Proposing Release”).

³ SEC Release 33-8995; 34-59192; File No. S7-15-08; Modernization of Oil and Gas Reporting (the “Adopting Release”).

("PRMS")⁴ generally, many of the revised definitions are designed to be consistent with the PRMS and use similar terminology and concepts.

Pricing Mechanism for Oil and Gas Reserves Estimation

The 12-month Average Price Method. "Proved oil and gas reserves" are defined to include only those quantities that are "economically producible" based on "existing economic conditions." Under the new rules, a company must determine economic producibility by using a 12-month average price, calculated as the unweighted arithmetic average of the first-day-of-the-month price for each month within the 12-month period prior to the end of the reporting period, unless prices are defined by contractual arrangements, excluding escalations based upon future conditions.⁵ For example, a company with a reporting year-end of December 31 would determine its reserves estimates for its annual report based on the average of the prices for oil or gas on the first day of every month from January through December. The current rule requires the use of a daily spot price taken on the last day of a company's fiscal year.⁶

The SEC rejected some commenters' arguments that management's estimates of future prices should be used, stating that the objective of reserves estimation in SEC filings is to provide the public with comparable information about volumes, not fair value, of a company's reserves, and to enable investors to compare the business prospects of different companies. If the objective were to provide fair-value information, then they believe a pricing system that incorporates assumptions about estimated future market prices and costs related to extraction could be a more appropriate basis for estimation. The SEC adopted a 12-month average historical price rule to determine the economic producibility of reserves quantities because it increases comparability between companies' oil and gas reserve disclosures, while mitigating any additional variability that a single-day price may have on reserve estimates. Companies that do not consider that the use of historical prices captures management's outlook of the future are now permitted to present a sensitivity analysis in their filings based on future pricing scenarios or management's planning prices.

In response to several commenters that recommended there be more time between the end of the measurement period and the end of the company's fiscal year to facilitate calculations and reporting, the SEC noted that the use of first-day-of-the-month prices (instead of last-day-of-the-month prices) will provide companies some more time to prepare the disclosure without sacrificing comparability.

Same Price Used for Disclosure and SEC Accounting Purposes. The SEC had originally proposed the use of a 12-month average price to estimate reserves for disclosure purposes, but a single-day, year-

⁴ The Petroleum Resources Management System is a widely accepted standard for the management of petroleum resources developed by several industry organizations.

⁵ Where price is set by contractual arrangements, that contractual price must be used to establish economic producibility.

⁶ While the new rules make clear how to determine the price to use, there is no guidance for determining what cost assumptions to use.

end price for accounting purposes (except for reporting the information required by FAS 69). For companies using either the successful-efforts accounting method described in Statement of Financial Accounting Standard No. 19 prescribed by the Financial Accounting Standards Board (“FASB”) or the full-cost method set forth in Rule 4-10(c) of Regulation S-X, the quantity of reserves is used to determine the depreciation, depletion and amortization of certain capitalized costs included on the balance sheet, even though reserves themselves are not included on the balance sheet. In addition, companies using the full-cost accounting method would have been required to use the single-day, year-end rate for purposes of determining the limitation on capitalized costs (*i.e.* the ceiling test). This proposed approach was widely criticized as commenters argued it would lead to confusing disclosure and harm comparability. In the final rules, the SEC extended the 12-month average price method to its accounting rules and indicated that it will continue to communicate with the staff of the FASB to align the FASB’s accounting standards with the SEC’s 12-month average price method under the new rules. In conjunction with this change, the SEC staff will eliminate portions of Staff Accounting Bulletin (SAB) Topic 12:D.3 that permit consideration of the impact of price increases subsequent to the period-end on the ceiling limitation test.

The SEC noted that the change from single-day, year-end prices to the 12-month average for the purpose of the ceiling test under the full-cost accounting method may have the effect of accelerating or delaying the timing of write-downs. For example, in periods of rising oil and gas prices, the use of a 12-month average may lead to a ceiling test write-down that would not otherwise have been required based on a single day, year-end price. The opposite may occur in periods of declining prices. The SEC noted that a company should discuss such situations, if material, particularly when pricing trends indicate the possibility of a future write-down in the MD&A and, where appropriate, the notes to the financial statements.

Estimation of Non-Traditional or Unconventional Resources

Revised Definition of “Oil and Gas Producing Activities.” The adopted rules revise the SEC’s definition of “oil and gas producing activities” to include “non-traditional” or “unconventional” sources of oil and gas that involve extraction by means other than “traditional” oil and gas wells. Those sources are explicitly excluded under the current rules. Non-traditional sources include bitumen extracted from oil sands and oil and gas extracted from coal and shales. In addition, as proposed, the final rules amend the definition of “oil and gas producing activities” to include activities relating to the processing or upgrading of natural resources from which synthetic oil or gas can be extracted.⁷

⁷ However, notwithstanding the expanded scope of the definition of “oil and gas producing activities,” this definition would continue to exclude the transporting, refining, processing (other than field processing of gas to extract liquid hydrocarbons by the company and the upgrading of natural resources extracted by the company other than oil or gas into synthetic oil or gas) or marketing oil and gas; the production of natural resources other than oil, gas, or natural resources from which synthetic oil and gas can be extracted; and the production of geothermal steam.

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The SEC stated that the amendment shifts the focus of the definition of “oil and gas producing activities” away from the extraction technology that is used and towards the final product of such activities. The amended definition states specifically that oil and gas producing activities include the extraction of saleable hydrocarbons, in the solid, liquid, or gaseous state, from oil sands, shale, coalbeds, or other nonrenewable natural resources which are intended to be upgraded into synthetic oil or gas, and activities undertaken with a view to such extraction.

Disclosure by Final Product. The adopted rules require the presentation of a table separating reserves by final product. The table will distinguish between final products that are traditional oil or gas from final products of synthetic oil or gas. The SEC stated that the distinction between a company’s traditional and unconventional activities is an important one from an investor’s perspective because many of the unconventional activities are costlier, and therefore have a much higher threshold of economic producibility. The SEC stated that, with the disclosure in the new table, investors will be able to identify resources in projects that produce synthetic oil or gas that may be more sensitive to economic conditions from other resources.

The adopted rules prohibit a company from including coal and oil shale that is not intended to be converted into oil and gas as oil and gas reserves. If a company extracts a resource other than oil or gas, such as bitumen, and sells the product without processing it into synthetic oil and gas, it must disclose reserves of that other natural resource.

Definition of “Proved Oil and Gas Reserves”

The adopted rules revise the definition of “proved oil and gas reserves” in several significant respects. The SEC notes that the current definition of the term “proved oil and gas reserves” incorporates certain specific concepts such as “lowest known hydrocarbons” which limit a company’s ability to claim proved reserves in the absence of information on fluid contacts in a well penetration, notwithstanding the existence of other engineering and geoscientific evidence. Under the new rules, the definition is revised to permit the use of new reliable technologies to establish the reasonable certainty of proved reserves and to determine levels of lowest known hydrocarbons and highest known oil through methods other than well penetrations. In addition, under the new rules, a company may claim proved reserves beyond those development spacing areas that are immediately adjacent to developed spacing areas if the company can establish with reasonable certainty that these reserves are economically producible. These revisions are designed to permit the use of alternative technologies to establish proved reserves in lieu of requiring companies to use specific tests, and therefore to be more flexible as technology changes.

Definition of “Reasonable Certainty”

The definition of “proved oil and gas reserves” relies on the term “reasonable certainty” which previously was not defined in Rule 4-10. The new rules adopt the PRMS standard of “high degree of confidence that

the quantities will be recovered.”⁸ The SEC clarified in the new definition that having a “high degree of confidence” means that a quantity is “much more likely to be achieved than not, and, as changes due to increased availability of geoscience (geological, geophysical, and geochemical), engineering, and economic data are made to estimated ultimate recovery (EUR) with time, reasonably certain EUR is much more likely to increase or remain constant than to decrease.”

The new definition of “reasonable certainty” permits the use of both deterministic methods and probabilistic methods for estimating reserves. If deterministic methods are used, reasonable certainty means a high degree of confidence that the quantities will be recovered. If probabilistic methods are used, there should be at least a 90% probability that the quantities actually recovered will equal or exceed the estimate.

Definition of “Developed Oil and Gas Reserves”

Consistent with PRMS and current definitions, developed oil and gas reserves are defined as reserves that can be expected to be recovered through existing wells with existing equipment and operating methods or in which the required equipment is relatively minor compared to the cost of a new well, or through installed extraction equipment and infrastructure operational at the time of the reserves estimate if the extraction is by means not involving a well.

Definition of “Undeveloped Oil and Gas Reserves”

The new rules allow the inclusion of undeveloped reserves if there is reasonable certainty of economic producibility, regardless of whether the reserves are located in development spacing areas immediately adjacent to the development spacing area containing a producing well, or at a greater distance from productive units.⁹ This represents a significant change from the current approach, which imposes a “reasonable certainty” standard for reserves in drilling units immediately adjacent to the drilling unit containing a producing well, and a “certainty” standard for reserves in drilling units beyond the immediately adjacent drilling units.

Under the proposed rules, a company would have been prohibited from assigning proved status to undrilled locations if a development plan had not been adopted indicating that the locations are scheduled to be drilled within five years, unless it disclosed unusual circumstances that justify a longer time. Several commenters objected that large, complex or remote projects commonly require more than five years to develop. In response to those comments, under the adopted rules undrilled locations may be classified as having undeveloped reserves even where drilling is not scheduled to begin within five years, if specific (not necessarily “unusual”) circumstances justify a longer time.

⁸ The definition of “reasonable certainty” suggested in the Proposing Release was “much more likely to be achieved than not.” However, commenters recommended using a definition that followed more closely the PRMS standard.

⁹ In response to comments received, the SEC has replaced the term “drilling units” used in the current rules with “development spacing areas.”

The new rules also allow a company to include in undeveloped reserves quantities of oil that can be recovered through improved recovery projects, and expand the technologies that a company can use to establish reserves. The new rules expand the definition of “undeveloped oil and gas reserves” to permit the use of techniques that have been proved effective by actual production from projects in the same reservoir or an “analogous reservoir”¹⁰ or “by other evidence using reliable technology that establishes reasonable certainty.” This is a significant liberalization of the current requirements, which permit a company to include quantities of oil within reserves only if techniques have been proved effective by actual production from projects in the area and in the same reservoir.

Definition of “Reliable Technology”

The new rules adopt a principles-based definition of “reliable technology” which broadens the types of technologies that a company may use to establish its reserves estimates. For example, under the current rules companies must use actual production or flow tests to meet the “reasonable certainty” standard necessary to establish the proved status of their reserves.¹¹ The new rules define “reliable technology” as a grouping of one or more technologies (including computational methods) that has been field tested and has been demonstrated to provide reasonably certain results with consistency and repeatability in the formation being evaluated or in an analogous formation. The SEC notes that technologies have developed and will continue to develop, improving the quality of information that can be obtained from existing tests and creating entirely new tests that it cannot yet envision. The new definition permits the use of a new technology or a combination of technologies once a company can establish and document its reliability.

The new rules require that a company include a “general discussion” of the technologies used to establish reserve estimates in the company’s first filing with the SEC and in connection with material additions to reserves. The required disclosure would be limited to a concise summary of the technology or technologies used to create the estimate, and a company would not be required to disclose proprietary technologies, or a proprietary mix of technologies, at a level of specificity that would cause competitive harm.¹²

¹⁰ For estimating *proved* reserves, an analogous reservoir is defined in the new rules to be one that shares the following characteristics with the reservoir of interest: same geological formation (but not necessarily in pressure communication with the reservoir of interest), same environment of deposition, similar geological structure, and same drive mechanism.

¹¹ Notwithstanding this definition, in the past the SEC has recognized that flow tests can be impractical in certain areas, such as the Gulf of Mexico, due to environmental restrictions, and has not objected to disclosure of reserves estimates for these restricted areas based on alternative technologies.

¹² However, the SEC notes that its staff, as part of its review and comment process, may continue to request companies to provide supplemental data, consistent with current practice, which under the new rules may include information sufficient to support a company’s conclusion that a technology or mix of technologies used to establish reserves meets the definition of “reliable technology.”

New Definition of “Reserves”

To add clarity to the definition of “proved reserves,” the SEC has added a definition of the term “reserves.” The definition aims to describe more completely the criteria that an accumulation of oil, gas, or related substances must satisfy to be considered reserves (of any classification), including non-technical criteria such as legal rights. Under the new rules, “reserves” are the estimated remaining quantities of oil and gas and related substances anticipated to be economically producible, as of a given date, by application of development projects to known accumulations. In addition, there must exist, or there must be a reasonable expectation that there will exist, the legal right to produce or a revenue interest in the production of oil and gas, installed means of delivering oil and gas or related substances to market, and all permits and financing required to implement the project.

The SEC’s definition of reserves differs from the PRMS definition in one notable respect. While the PRMS definition is based on “commerciality,” the definition adopted by the SEC is based on “economic producibility.” The SEC stated that the “commerciality” concept introduces a subjective aspect to the price used to establish existing economic conditions by factoring in the reporting company’s “hurdle” rate of return, and therefore reduces the comparability of disclosure among companies.

OPTIONAL DISCLOSURE OF PROBABLE AND POSSIBLE RESERVES

The new rules permit the optional disclosure of probable and possible reserves, in addition to the disclosure of proved reserves. By allowing disclosure of all three classifications of reserves, the SEC aims to enable companies to provide investors with more insight into the potential reserves base that management may use as a basis for decisions to invest in resource development.

Probable Reserves

The new rules define “probable reserves” as those additional reserves that are less certain to be recovered than proved reserves but which, in sum with proved reserves, are as likely as not to be recovered. The definition allows for the use of both deterministic and probabilistic methods for establishing probable reserves. When deterministic methods are used, it is as likely as not that actual remaining quantities recovered will equal or exceed the sum of estimated proved plus probable reserves. When probabilistic methods are used, there must be at least a 50% probability that the actual quantities recovered will equal or exceed the proved plus probable reserves estimates. This definition was derived from the PRMS definition of the term “probable reserves.”

Possible Reserves

The new rules define “possible reserves” as those additional reserves that are less certain to be recovered than probable reserves. When deterministic methods are used to establish possible reserves, the total quantities ultimately recovered from a project have a low probability to exceed the sum of proved, probable, and possible reserves. When probabilistic methods are used, there must be at least a 10% probability that the actual quantities recovered will equal or exceed the sum of proved, probable, and

possible estimates. This definition is also consistent with the PRMS definition of the term “possible reserves.”

Resources Not Considered Reserves

Under the new rules, the SEC will continue to prohibit disclosure of oil and gas resources *other than* reserves and any estimated values of such resources unless such disclosure is required to be included in the document by foreign or state law. The only exception is for SEC filings related to an acquisition, merger, or consolidation, if the company previously provided those estimates to a person that is offering to acquire, merge, or consolidate with the company or otherwise to acquire the company’s securities. The SEC noted that this exception is intended to avoid situations where a company’s shareholders are at an informational disadvantage compared to a counterparty when assessing a proposed merger.

PREPARATION OF RESERVES ESTIMATES AND RESERVES AUDITS

The final rules require that a company provide a general discussion of the internal controls used to assure objectivity in the reserves estimation process and disclosure of the qualifications of the technical person primarily responsible for preparing the reserves estimates. Similar disclosure is required about the technical person responsible for conducting any reserves audit. These disclosures are required regardless of whether the reserves preparers or auditors are employees of the company or a third party. This approach differs from the SEC’s proposed rules, which envisioned extensive disclosure regarding the qualifications of the technical person primarily responsible for preparing a company’s reserves estimates or conducting a reserves audit, including disclosure of a specified list of criteria relating to education, experience, licensing and organization membership.

The SEC had sought comment on whether the rules should require a company to retain an independent third party to prepare, or conduct a reserves audit of, the company’s reserves estimate. In response to comments received, the SEC did not adopt this requirement.

Filing of Third-Party Reports. The new rules require that if a company represents that a third party prepared the reserves estimates or conducted a reserves audit of the reserves estimates, the company must file a report of the third party as an exhibit to the relevant filing. The report to be filed need not be the complete reserves report, but could be a shorter-form report incorporating specific information prescribed by the new rules regarding the scope of work undertaken and the conclusions of the third party. The required disclosure is based on the Society of Petroleum Engineers audit report guidelines and includes:

- the purpose for which the report is being prepared and for whom it is prepared;
- the effective date of the report and the date on which the report was completed;
- the proportion of the company’s total reserves covered by the report and the geographic area in which the covered reserves are located;

- the assumptions, data, methods, and procedures used to conduct the reserves audit, including the percentage of the company's total reserves reviewed in connection with the preparation of the report, and a statement that such assumptions, data, methods, and procedures are appropriate for the purpose served by the report;
- a discussion of primary economic assumptions;
- a discussion of the possible effects of regulation on the ability of the registrant to recover the estimated reserves;
- a discussion regarding the inherent risks and uncertainties of reserves estimates;
- a statement that the third party has used all methods and procedures as it considered necessary under the circumstances to prepare the report; and
- the signature of the third party.

In addition, if the report is related to a reserves audit, it must contain a brief summary of the third party's conclusions with respect to the reserves estimates.

The new rules also permit a company to disclose that it has hired a third party to perform a review of the process for estimating reserves as contemplated by the Society of Petroleum Engineers (SPE) reserves auditing standards. If it does, the process review will be treated similarly to a reserves audit report. Accordingly, a process report will have to be filed as an exhibit to the filing. In addition, if a reserves audit report or process review report is included in, or incorporated into, a Securities Act registration statement, the company must file a consent of the third party as an exhibit to that filing.

CODIFICATION AND EXPANSION OF REQUIRED DISCLOSURES IN REGULATION S-K

In addition to modifying the rules related to reserves identification and classification, the new rules codify and expand the disclosures required to be made by oil and gas companies in a new Subpart 1200 to Regulation S-K. This new subpart largely carries forward the existing requirements of Industry Guide 2, which it replaces, but also updates certain requirements, and clarifies the level of detail required and the format of tabular presentations. The new Subpart 1200 will also apply to foreign private issuers, as discussed below.

Geographic Area Disclosure

The new rules revise the definition of the term "by geographic area" and require disclosure of reserves and production by individual country, by groups of countries within a continent, or by continent, as appropriate for meaningful disclosure under a company's particular circumstances. This definition is substantially the same as the definition currently provided in SFAS 69. However, the new rules add specific percentage thresholds to the geographic breakdowns of reserves estimates and production.

With respect to production, the final rules require disclosure of production in each country or field containing 15% or more of the company's proved oil and gas reserves (based on barrels of oil equivalent) unless prohibited by the country in which the reserves are located. With respect to reserves estimates, the final rules require disclosure of reserves in countries containing more than 15% of the company's

proved reserves unless prohibited by the country in which the reserves are located. As with the production disclosure, this 15% threshold would be based on the company's total global oil and gas proved reserves, rather than on individual products, as the SEC had originally proposed.¹³

New Tabular Disclosures

The new rules will require that many of the reserves disclosures and other disclosures be in tabular format.

Reserves. New Item 1202 requires disclosure, in the aggregate and by geographic area, of reserves estimates using prices and costs under existing economic conditions, for each product type, in the following categories:

- Proved developed reserves;
- Proved undeveloped reserves;
- Total proved reserves;
- Probable developed reserves (optional);
- Probable undeveloped reserves (optional);
- Possible developed reserves (optional); and
- Possible undeveloped reserves (optional).

Even though disclosure of probable and possible reserves is optional, if a company chooses to make such disclosure, it must provide the same level of geographic detail as required for proved reserves and must state whether the reserves are developed or undeveloped.

The final rules did not adopt the proposed requirement for disclosure of reserves separated into continuous and conventional accumulations. However, companies will be required to make disclosure based on the final product they sell.

Optional Reserves Sensitivity Table. As discussed above, the new rules require a company to determine whether its oil or gas resources are economically producible based on a 12-month average price. The SEC is also allowing companies to disclose the sensitivity that oil and gas reserves have to price fluctuations. If a company chooses to provide such disclosure, it must also disclose the price and cost schedules and assumptions on which the alternate reserves estimates are based.

Oil and Gas Production; Disclosure of Average Sales Prices. Item 1204 requires disclosure, for each of the prior three fiscal years, of production, by final product sold, of oil, gas, and other products. In addition, the company must disclose, for the same periods, the average sales price (including transfers)

¹³ The SEC did not adopt its proposal to require the disclosure of reserves by sedimentary basin or field, sharing commenters' concerns that there is potential for competitive harm from such disclosure. In addition, the rule does not require disclosure of reserves in a country containing 15% of the company's reserves if that country prohibits disclosure of reserves in a particular field and disclosure of reserves in that country would have the effect of disclosing reserves in particular fields.

per unit of oil, gas and other products produced; and the average production cost, not including *ad valorem* and severance taxes, per unit of production. Unlike the current Industry Guide 2 requirement, this disclosure must be made by geographical area, for each country and field containing 15% or more of the registrant's proved reserves, expressed on an oil-equivalent-barrels basis.

The new rules also codify the existing instructions in the current Industry Guide and add a new instruction clarifying that disclosures under this item must be based on the end product.

Disclosure Relating to Proved Undeveloped Reserves

The proposing release contained a requirement for detailed tabular disclosure of the aging of proved undeveloped reserves (PUDs). The SEC revised its proposal to instead require a company to disclose the following in narrative form:

- the total quantity of PUDs at year-end;
- any material changes in PUDs that occurred during the year, including PUDs converted into proved developed reserves;
- investments and progress made during the year to convert PUDs to proved developed oil and gas reserves; and
- an explanation of the reasons why material concentrations of PUDs in individual fields or countries have remained undeveloped for five years or more after disclosure as PUDs.

The SEC decided that rather than requiring forward-looking information about a company's plans to develop reserves, the disclosure of a company's verifiable, established track record of converting such reserves, including the ability to obtain financing for such activities, would be a better indication of the likelihood of that company's success in developing reserves in the future.

Codification of Certain Other Current Requirements

The new Subpart 1200 in Regulation S-K codifies certain other disclosure requirements from Industry Guide 2 without substantive amendments, including Drilling and Development Activities (Item 1205); Present Activities (Item 1206); Delivery Commitments (Item 1207); and Oil and Gas Properties, Wells, Operations, and Acreage (Item 1208).

CHANGE IN ACCOUNTING PRINCIPLE OR ESTIMATE

The SEC stated in the Adopting Release that any accounting change resulting from the changes in definitions and required pricing assumptions in Rule 4-10 should be treated as a change in accounting principle that is inseparable from a change in accounting estimate that does not require retroactive revision, although such a change would require recognition in the independent auditor's report through the addition of an explanatory note.

GUIDANCE FOR MD&A DISCLOSURE BY OIL AND GAS COMPANIES

The Proposing Release proposed to add a new item to Regulation S-K that would have specified topics that a company should address as part of its MD&A or in a separate section. The final rules do not adopt the proposed item as part of Regulation S-K, because it is intended to be guidance and not a specific disclosure item. However, the Adopting Release outlines a number of topics that an oil and gas company should discuss if they constitute, involve or indicate known trends, demands, commitments, uncertainties and events that are reasonably likely to have a material effect on the company. These topics include:

- changes in proved reserves and, if disclosed, probable and possible reserves, and the sources to which such changes are attributable, including changes made due to changes in prices, technical revisions, and changes in the status of any concessions held (such as terminations, renewals, or changes in provisions);
- technologies used to establish the appropriate level of certainty for any material additions to, or increases in, reserves estimates, including additions or increases that are the result of any of the newly adopted rules;
- prices and costs, including the impact on depreciation, depletion and amortization as well as the full-cost ceiling test;
- performance of currently producing wells, including water production from such wells and the need to use enhanced recovery techniques to maintain production from such wells;
- performance of any mining-type activities for the production of hydrocarbons;
- the company's recent ability to convert proved undeveloped reserves to proved developed reserves, and, if disclosed, probable reserves to proved reserves and possible reserves to probable or proved reserves;
- the minimum remaining terms of leases and concessions;
- material changes to any line item in the new tabular disclosure required by the new Subpart 1200;
- potential effects of different forms of rights to resources, such as production-sharing contracts, on operations; and
- geopolitical risks that apply to material concentrations of reserves.

Companies may include this discussion either in the MD&A section or, if they believe it is more appropriate, in the section that includes the tables containing the relevant oil and gas disclosure, with appropriate cross-references.

CONFORMING CHANGES TO FORM 20-F

The SEC has also made revisions to Form 20-F, which is used by foreign private issuers to file annual reports and Exchange Act registration statements.

The updated Form 20-F will no longer contain "Appendix A to Item 4.D—Oil and Gas," which provided guidance for oil and gas disclosures by foreign private issuers, but was significantly shorter and contained far less guidance regarding disclosure than Guide 2 and now Subpart 1200. Instead, Form 20-F will incorporate the new Subpart 1200 of Regulation S-K, which will result in a significant expansion of the

required disclosures for non-U.S. oil and gas companies.¹⁴ The SEC stated that requiring both domestic and foreign private issues to follow the same guidelines will promote more consistent and comparable disclosures among oil and gas companies.

The SEC has clarified that the new disclosure requirements would not apply to Canadian foreign private issuers which use Form 40-F under the Multi-Jurisdictional Disclosure System and comply with the similar (though not identical) rules under NI 51-101 in Canada.

IMPLEMENTATION

The new rules will become effective for registration statements filed on or after January 1, 2010 and for annual reports on Forms 10-K and 20-F for fiscal years ending on or after December 31, 2009. Voluntary early compliance is not permitted, and a company may not apply the new rules to disclosures in quarterly reports prior to the first annual report in which the revised disclosures are required.

Discussions with FASB and IASB. The SEC has noted that it is undertaking discussions with the FASB and the International Accounting Standards Board (“IASB”) regarding revisions to the accounting standards promulgated by these bodies to ensure conformity with the new rules. Depending on the outcome of these discussions, the SEC will consider whether to delay the mandatory compliance date.

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¹⁴ A foreign private issuer will continue to be allowed to exclude required disclosures about reserves and agreements if its home country prohibits the disclosures.

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