

November 20, 2009

Oil and Gas Reserves Disclosure

SEC Division of Corporation Finance Issues New Compliance and Disclosure Interpretations on Oil and Gas Rules

SUMMARY

On October 26, 2009, the SEC's Division of Corporation Finance (the "Division") issued new Compliance and Disclosure Interpretations (the "C&DIs") on the revised oil and gas reporting rules adopted by the SEC on December 31, 2008.

The C&DIs, some of which address specific questions raised by preparers of reserves disclosures, provide guidance, among other things, on the new definitions of reserves (proved, probable and possible), development projects and undeveloped oil and gas reserves and seek to clarify certain of the new disclosure requirements. The C&DIs apply to filings by both U.S. and foreign private issuers that are SEC registrants engaged in oil and gas producing activities and are intended to be updated and supplemented from time to time.

Separately, on October 30, 2009, the Office of the Chief Accountant of the SEC issued Staff Accounting Bulletin No. 113 containing updated guidance on accounting rules related to the oil and gas industry. The guidance updates Topic 12 of the Codification of Staff accounting bulletins to make it consistent with the SEC's new oil and gas rules.

The SEC's new rules, the C&DIs and Staff Accounting Bulletin No. 113 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

On December 31, 2009, the SEC adopted new oil and gas reporting rules set forth in Regulation S-X and Regulation S-K designed to reflect the significant changes in the oil and gas industry that have taken place in the three decades since the oil and gas reporting requirements were first adopted, including technological advances and changes in the types of projects in which oil and gas companies invest their capital.

Among the most significant changes in the new rules are the use of 12-month average prices in determining reserves for both disclosure and accounting purposes, a new principles-based definition of reliable technology, the inclusion of non-traditional reserves in disclosure of oil and gas reserves and the option to disclose probable and possible reserves.¹

The C&DIs are the first guidance issued by the Division in relation to the SEC's new rules.²

NEW INTERPRETATIONS

The C&DIs provide guidance, among other things, on the new definitions of reserves (proved, probable and possible), development projects and undeveloped oil and gas reserves. We provide below highlights of some of the interpretations issued by the Division.

Reserves

Highest Known Oil (HKO). Pursuant to the new definitions, proved oil reserves may be assigned in portions structurally higher than the HKO elevation of the reservoir only if geoscience, engineering, or performance data and reliable technology establish the higher contact with reasonable certainty through reliable technology. For portions of the reservoir that do not meet this reasonable certainty test, probable or possible reserves may be assigned based on reservoir fluid properties and pressure gradient interpretations. In the C&DIs, the Division clarifies that, with regard to reserves above the HKO elevation, if it is equally likely that oil or gas is present, the lower value product should be assigned and if the lower value product is gas and there is no market for gas in that location, or no way to transport gas to a market, then any assumed gas cap volume that may or does exist above the HKO elevation may not be classified as reserves.

¹ For additional information on the SEC's new oil and gas reporting rules, please see SEC Release 33-8935; 34-58030; File No. S7-15-08; *Modernization of the Oil and Gas Reporting Requirements*; SEC Release 33-8995; 34-59192; File No. S7-15-08; *Modernization of Oil and Gas Reporting* (the "Adopting Release"); and our Memorandum, *Oil and Gas Reserves Disclosures*, dated January 26, 2009.

² The C&DIs are available on the SEC's website at:
<http://www.sec.gov/divisions/corpfin/guidance/oilandgas-interp.htm>

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Well Penetration. In line with previous Staff positions, the Division states that reserves should not be assigned without well penetration of the subject reservoir (rock volume) in the contiguous area that yields technical information sufficient to support the attributed reserve category. The Division also states that unpenetrated, pressure-separated fault blocks should not be considered to contain reserves of any category until penetrated by a well.

Proved Reserves

Production Sharing Contracts. Pursuant to the SEC's new definitions, recognition of reserves requires, among other things, the existence of the legal rights to produce or to share a revenue interest in the production and all permits necessary to implement the project or a reasonable expectation that these rights and permits will be obtained. In the C&DIs, the Division states that a company may not assign *proved* reserves under a production sharing contract prior to obtaining all governmental approvals from the host country, since production sharing contracts are entered into in countries where the government claims ownership of the mineral rights.

Probable and Possible Reserves

Unproved Reserves Without Associated Proved Reserves. In the C&DIs, the Division states that a company may report unproved reserves in areas where it does not, or cannot, assign associated proved reserves "only in exceptional cases". The Division mentions as examples of such exceptional cases (i) development projects where engineering, geological, marketing, financing and technical tasks have been completed, but final regulatory approval is lacking and (ii) improved recovery projects, at or near primary depletion, that await production response.

Lowest Known Hydrocarbon (LKH). The SEC's new definitions provide that, absent data on fluid contacts, proved quantities in a reservoir are limited by the LKH as seen in a well penetration unless geoscience, engineering or performance data and reliable technology establishes a lower contact with reasonable certainty. In the C&DIs, the Division clarifies that it may be acceptable to assign probable or possible reserves below LKH if that volume of reserves meets the test for either probable or possible reserves. If there is no data below LKH, no reserves of any kind can be assigned.

Development Project

Refinement of the Definition of Development Project. The SEC's new rules define a development project as the means by which petroleum resources are brought to the status of economically producible. In the C&DIs, the Division refines the definition of a development project, specifying that a development project is typically a single engineering activity with a distinct beginning and end which, when completed, results in the production, processing or transportation of crude oil or natural gas. The Division further clarifies that a project typically has a definite cost estimate, time schedule and investment decision; it is approved for funding by management and may include all classifications of reserves; it will be fully

operational after the completion of the initial construction or development; and its scope and scale are such that, if the project were terminated before completion for whatever reason, a significant portion of the previously invested capital would be lost.

The Division also addresses the specific case where an investment decision has been made to develop only a portion of the primary, secondary or tertiary reserves. In this case, the Division considers that the remainder of the reserves should not be recognized as proved reserves until such time as management has made an investment decision to develop these additional reserves, the requisite level of certainty has been demonstrated from the initial portion of the development or by other means, and the additional development is within five years of being initiated.

Undeveloped Oil and Gas Reserves

Five-Year Time Frame. Pursuant to the SEC's new rules, undrilled locations can be classified as having undeveloped reserves only if a development plan has been adopted indicating that they are scheduled to be drilled within five years, unless specific circumstances justify a longer time.³ In the C&DI's, the Division clarifies that although several types of projects — such as constructing offshore platforms — by their nature customarily take a longer time to develop and therefore often do justify longer time periods, the determination of whether any specific circumstances justify a longer time period must always take into consideration all of the facts and circumstances. The Division considers that any extension beyond five years should be the exception, and not the rule.⁴

Specific Circumstances. The Division specifies some of the factors that a company should consider in determining whether or not circumstances justify recognizing reserves even though development may extend past five years, such as levels of ongoing significant development activities in the area to be developed, the company's historical record of completing development of comparable long-term projects, the amount of time in which the company has maintained leases, or booked reserves, without significant development activities or the extent to which the company has followed a previously adopted development plan.

The Division also states that a company's decision to develop a field slowly in order to extend its economic life does not justify recognizing proved undeveloped reserves in the field beyond five years.

³ The Division states that there is no difference between the term "scheduled to be drilled" and the term "initiation of development" used in the Petroleum Resource Management System ("PRMS"), a standard for the management of petroleum resources developed by several industry organizations.

⁴ Under PRMS, while five years is recommended as a benchmark, a longer time frame could be applied where, among other things, development of economic projects are deferred at the option of the producer for, among other things, market-related reasons, or to meet contractual or strategic objectives.

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Adoption of a Development Plan. The Division states that the mere intent to develop, without more, does not constitute “adoption” of a development plan and therefore would not, in itself, justify recognition of reserves; rather, adoption requires a “final investment decision”. The Division does not elaborate on what constitutes a final investment decision.

Existing Economic Conditions; Prices and Costs. The instructions relating to the price to be used to estimate reserves (*i.e.*, the 12-month unweighted average price, based on the first-day-of-the-month price for each month) are included in the definition of proved reserves in the SEC’s new rules. The Division clarifies that probable and possible reserves should be evaluated using the same price as the price used for the evaluation of proved reserves.

The C&DIs also state that the new definition of “existing economic conditions” does not require registrants to amend their existing procedures for determining costs.

Undrilled Locations. The definition of undeveloped oil and gas reserves provides, among other things, that reserves on undrilled acreage shall be limited to those directly offsetting development spacing areas that are reasonably certain of production when drilled, unless evidence using reliable technology exists that establishes “reasonable certainty of economic producibility” at greater distance. In the C&DIs, the Division states that the standard of “reasonable certainty of economic producibility”, which by its terms refers to proved reserves, does not mean that a company may not assign probable or possible undeveloped reserves beyond areas containing proved undeveloped reserves if established by reliable technology.

INTERPRETATIONS ON DISCLOSURE

The Division also seeks to clarify certain of the new disclosure requirements introduced by the SEC. These include the following:

Total Estimates

The SEC’s new rules provide that a deterministic estimate is a method of estimating reserves or resources using a single value for each parameter (from the geoscience, engineering, or economic data) in the reserve calculation. Under the deterministic methodology, proved reserves may be assigned if there is a high degree of confidence that the quantities will be recovered; probable reserves may be assigned when it is as likely as not that actual remaining quantities recovered will exceed the sum of estimated proved plus probable reserves; and possible reserves may be assigned when the total quantities ultimately recovered from a project have a low probability of exceeding proved plus probable plus possible reserves. In the C&DIs, the Division confirms that it is not appropriate to sum up the individual deterministic estimates for proved, probable and possible reserves into one total reserve estimate and report that estimate because the categories of proved, probable and possible reserves have

different levels of certainty. The individual estimates for each category must be disclosed as separate estimates, with the difference in certainty for each estimate fully explained in accordance with Regulation S-K.

Disclosure by Countries

Regulation S-K requires, among other things, disclosure of reserves and production by geographic area and for each country containing 15% or more of the registrant's proved reserves. The C&DIs clarify that reserve quantities attributable to equity method investees should be combined with reserve quantities attributable to consolidated entities for purposes of identifying countries containing 15% or more of the registrant's reserves.⁵

ACCOUNTING RULES

On October 30, 2009, the Office of the Chief Accountant of the SEC issued Staff Accounting Bulletin No. 113 containing updated guidance on how the SEC Staff interprets accounting rules related to the oil and gas industry. The guidance updates Topic 12 of the Codification of Staff accounting bulletins to make it consistent with the SEC's new oil and gas rules. The principal revisions of the Staff's guidance include (i) replacing the use of a year-end price for determining estimated quantities of oil and gas reserves with 12-month average prices, (ii) eliminating the option to use post-quarter-end prices to evaluate write-offs of excess capitalized costs under the full cost method of accounting and (iii) removing the exclusion of unconventional methods used in extracting oil and gas from oil sands or shale as an oil and gas producing activity.

On September 15, 2009, the FASB published for public comment a proposed accounting standard update, *Extractive Industries – Oil and Gas (Topic 932): Oil and Gas Reserve Estimation and Disclosures*, which is designed to align the FASB's disclosure requirements for publicly traded entities with significant oil and gas activities issuing their primary statements under U.S. GAAP with the SEC's new oil and gas rules.⁶ The comment period ended on October 15, 2009. The FASB expects the revised

⁵ The C&DIs do not specifically address whether, in addition to combining quantities for purposes of determining the 15% level, the SEC Staff would permit the disclosure of total reserve quantities attributable to consolidated entities and equity method investees. However, combined reserve disclosure would be consistent with the FASB proposed standard update referred to below under "Accounting Rules".

⁶ The proposed standard update of the FASB is available at: http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176156455926.

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update to be effective for annual reporting periods ending on or after December 31, 2009, and applied prospectively as a change in estimate.⁷

In 2004, the International Accounting Standard Board (“IASB”) set up an international project team to research the accounting for upstream extractive activities. On August 11, 2009, a working draft of a discussion paper was made available on the IASB’s website, presenting the project team’s findings and recommendations. The discussion paper is expected to be published for comment in the first quarter of 2010.⁸ The objective is to develop an International Financial Reporting Standard (“IFRS”) that would replace IFRS 6, *Exploration for and Evaluation of Mineral Resources*, which the IASB released in December 2004 as an interim measure pending completion of its comprehensive project. Although still in the discussion stage, the project team recommends adoption of the PRMS classification system rather than the SEC’s definitions.

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⁷ In addition, on October 9, 2009, the American Institute of Certified Public Accountants (“AICPA”) released for comment a working draft of AICPA Audit and Accounting Guide, *Entities with Oil and Gas Producing Activities*. The comment period will end on December 11, 2009.

⁸ The working draft of the IASB’s project team is available at:
<http://www.iasb.org/NR/rdonlyres/23F1424B-05E4-4BD1-AFD8-382125765D8E/0/ExtractivesDPworkingdraft10August2009.pdf>.

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