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SEC Final Rule — Modernization of Oil and Gas Reporting

On December 31, 2008 the Securities and Exchange Commission (the “SEC”) issued a final rule revising disclosure requirements relating to oil and gas reserves (the “Final Rule”). The Final Rule reflects the SEC’s consideration of comments received from stakeholders in response to the proposed rule issued by the SEC on June 27, 2008 (the “Proposed Rule”). The amendments are intended to modernize and update the oil and gas disclosure requirements (in their current form, Item 102 of Regulation S-K, Rule 4-10 of Regulation S-X and Industry Guide 2), to align them with current industry practices and to adapt to changes in technology. These revisions are intended to provide investors with a more meaningful and comprehensive understanding of oil and gas reserves and to facilitate comparison between companies.

The amendments will become effective on January 1, 2010. Companies will be required to begin complying with the new rules 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. Companies may not elect to follow the new disclosure rules prior to the effective date.

Introduction – PRMS Standards

Many of the new and revised definitions in the Final Rule are designed to be consistent with the Petroleum Resources Management System, the classification system for petroleum reserves and resources approved by the Society for Petroleum Engineers (“PRMS”). The SEC also based its definitions for the terms “deterministic estimate”, “probabilistic estimate” and “resources” on the Canadian Oil and Gas Evaluation Handbook.

However, unlike PRMS, the Final Rule will continue to require the use of historical prices and costs in reserves estimates, in order to promote comparability. Another significant difference, also aimed at comparability, is that, like the current rules, the Final Rule requires reserves to

be “economically producible”, whereas other classification systems only require extractive projects to be “commercial”. Finally, unlike PRMS but consistent with the Proposed Rule, the Final Rule does not classify resources beyond reserves, as the SEC’s staff (the “Staff”) does not propose to change its position that estimates of resources not classified as reserves may not be disclosed in SEC filings, except in certain limited circumstances.

Year-End Pricing – 12-Month Average Price

Currently, SEC rules require that a single-day, fiscal year-end spot price be used to determine economic producibility of oil and gas reserves. The Final Rule changes this to 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. A 12-month average price is considered to reflect “current economic conditions” by PRMS.

The Final Rule also adopts an optional reserves sensitivity table, which will allow companies to disclose additional information to investors, such as the sensitivity that oil and gas reserves have to price fluctuations. If a company chooses to provide such disclosure, it may choose the different scenario or scenarios, if any, that it wishes to disclose in the table, provided that it also discloses the price and cost schedules and assumptions on which the alternate reserves estimates are based. The optional reserves sensitivity analysis table is intended to provide investors with a better view of management's analysis of future prices.

Extraction of Bitumen and Other Unconventional Resources

The current definition of "oil and gas producing activities" explicitly excludes sources of oil and gas from "non-traditional" or "unconventional" sources, including bitumen extracted from oil sands and hydrocarbons extracted from coalbeds and shales. The Final Rule broadens the definition to include such unconventional resources by shifting the focus of the definition to the final product of producing activities regardless of the extraction technology used. The amended definition specifically includes the extraction of saleable hydrocarbons in the solid, liquid, or gaseous state, from oil sands, shale, coalbeds, or other nonrenewable natural resources that are intended to be upgraded into synthetic oil or gas, and activities undertaken with a view to such extraction.

Consistent with the SEC's traditional separation of "upstream" activities such as drilling and producing oil and gas from "downstream" activities such as refining, the Proposed Rule would not have allowed companies with their own on-site or local processing facilities to use the price of their processed product to determine economic producibility of the unprocessed product. Several commenters disagreed with this approach, arguing that a company should be able to consider the prices of self-processed resources when estimating oil and gas reserves because the economics of the processing plant are critical to the company's evaluation of the economic producibility of the resources. The Final Rule addresses these concerns

by requiring separation of reserves based on final product, not the pre-processed resource extracted from the ground, as proposed in the Proposed Rule. However, as the SEC continues to believe 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), categorization of reserves based on final product will distinguish final products that are traditional oil or gas from final products of synthetic oil or gas. The Final Rule will continue to exclude from the definition of "oil and gas producing activities" activities relating to transporting, refining, upgrading, processing or marketing oil and gas, consistent with the SEC's view that once resources are extracted, they should not be considered oil and gas reserves.

Reserves – Definitions

"Reserves", presently undefined under SEC rules, will be defined as 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 definition as adopted in the Final Rule was revised from the definition proposed in the Proposed Rule to make it more consistent with the PRMS definition. However, unlike the PRMS definition, the definition of "reserves" in the Final Rule is based on "economic producibility" rather than "commerciality". "Reserves" will be classified as proved, probable and possible according to the degree of certainty of recovery.

Reasonable Certainty

The Final Rule adopts the definition of "proved oil and gas reserves" substantially as proposed in the Proposed

Rule: “those quantities of oil and gas, which, by analysis of geoscience and engineering data, can be estimated with reasonable certainty to be economically producible — from a given date forward, from known reservoirs, and under existing economic conditions, operating methods, and government regulations — prior to the time at which contracts providing the right to operate expire, unless evidence indicates that renewal is reasonably certain, regardless of whether deterministic or probabilistic methods are used for the estimation”. In order to provide further guidance on the concept of “proved reserves”, the Final Rule defines the term “reasonable certainty” by reference to the PRMS standard of “high degree of confidence that the quantities will be recovered” — not by the “much more likely to be achieved than not” standard proposed in the Proposed Rule. The Final Rule clarifies 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”. When probabilistic methods are used, “reasonable certainty” means that there is at least a 90% probability that the quantities actually recovered will equal or exceed the stated volume. The Final Rule adds definitions for “deterministic estimate” and “probabilistic estimate”, as the two alternative methods by which a company may estimate its reserves.

Developed and Undeveloped Reserves

The Final Rule defines the terms “developed oil and gas reserves” and “undeveloped oil and gas reserves” without regard to the classification of reserves as proved or unproved. The definition of “developed oil and gas reserves” is broadened to include the extraction of resources using technologies other than production through wells, and, consistent with the PRMS, the revised definition includes reserves if the cost of any required equipment is relatively minor compared to the cost of a new well. The Final Rule amends the definition of undeveloped reserves by replacing the requirement that

productivity be “certain” for areas beyond the immediate area of known proved reserves with a “reasonably certain” requirement, and by permitting inclusion of quantities of oil that can be recovered through improved recovery projects. The definition imposes a five-year limit on maintaining undeveloped reserves absent “specific” circumstances, consistent with the PRMS, rather than absent “unusual” circumstances, as proposed in the Proposed Rule.

Unproved Reserves – “Probable Reserves” and “Possible Reserves”

As proposed in the Proposed Rule, the Final Rule makes optional disclosure of probable and possible reserves, which currently cannot be disclosed in SEC filings unless required to be disclosed by state or foreign law. The Staff hopes that this change will enable companies to provide investors with more insight into the potential reserves base that management of companies may use as their basis for decisions to invest in resource development.

The Final Rule adopts the definitions of “probable reserves” and “possible reserves” as proposed in the Proposed Rule, which definitions are consistent with the PRMS. “Probable reserves” includes 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. “Possible reserves” includes those additional reserves that are less certain to be recovered than 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 and at least a 10% probability that such quantities will equal or exceed the sum of proved, probable, and possible estimates.

Some commenters were concerned that disclosure of reserves estimates beyond proved reserves could increase the risk of litigation. By making disclosure of probable and possible reserves voluntary, a company will be able to decide on its own whether to provide the market with this disclosure, despite possible increased litigation risk.

Reliable Technology

Currently, a company generally must use actual production or flow tests to meet the “reasonable certainty” standard. In the past, the Staff has recognized that flow tests can be impractical in certain areas and has not objected to the use of alternative technologies in some cases. The Final Rule adds the defined term “reliable technology” to clarify the types of technology that can be used to establish “reasonable certainty”. “Reliable technology” is defined 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”. This new standard will permit the use of a new technology or a combination of technologies once a company can establish and document the reliability of that technology or combination of technologies. The definition as adopted in the Final Rule differs from the version proposed in the Proposed Rule in that it does not require that reliable technology be “widely accepted” or that it be proven empirically to lead to correct conclusions in 90% or more of its applications.

If a company has not previously disclosed reserves estimates in a filing with the SEC or is disclosing material additions to its reserves estimates, the company must disclose the technologies used to establish the appropriate level of certainty for reserves estimates from material properties included in the total reserves disclosed. The required disclosure will be limited to a concise summary and need not disclose proprietary technologies at a level of specificity that would cause competitive harm.

Additional Definitions

The Proposed Rule included proposed definitions for the terms “continuous accumulations” and “conventional accumulations”. However, as the Final Rules requires disclosure based on the end product sold, rather than based on the type of accumulation in which the reserves are found, these definitions were not adopted in the Final Rule. The Final Rule also includes additional definitions primarily to support and clarify the definitions discussed

above, including: (i) “analogous reservoir”, which appears in the definition of proved reserves and which was revised from the version proposed in the Proposed Release for greater consistency with the PRMS; (ii) “condensate”; (iii) “development project”; (iv) “estimated ultimate recovery”; and (v) “resources”.

Reserves – Additional Disclosure

Oil and Gas Reserves Tables

The Final Rule requires disclosure, in the aggregate and by geographic area, of reserves estimated using prices and costs under existing economic conditions, for each product type (i.e., oil, gas, synthetic oil, synthetic gas and other natural resource (e.g., unprocessed bitumen)), in the following categories: (i) proved developed; (ii) proved undeveloped; (iii) total proved; (iv) probable developed (optional); (v) probable undeveloped (optional); (vi) possible developed (optional); and (vii) possible undeveloped (optional).

The Proposed Rule would have required a table showing, for each of the last five fiscal years and by product type, proved undeveloped reserves (“PUDs”) converted to proved developed reserves by year and the net investment required in each year for such conversion. In response to comments received on this proposal, the Final Rule will instead require narrative disclosure of the following: (i) the total quantity of PUDs at year end; (ii) any material changes in PUDs that occurred during the year, including PUDs converted into proved developed reserves; (iii) investments and progress made during the year to convert PUDs to proved developed oil and gas reserves; and (iv) 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.

Geographic Disclosure

In order to provide investors with a more detailed understanding of the unique risks facing particular countries, the Final Rule requires disclosure of reserves and production by geographic area in a manner that is

more detailed than the current “groups of countries” standard. In cases where a particular country (or field, in the case of production) contains 15% or more of a company’s total global oil and gas proved reserves, based on barrels of oil equivalent, country-specific (or field-specific) disclosure will be required, unless such disclosure is prohibited by foreign law. Unlike the Proposed Rule, the Final Rule does not require disclosure of reserves by sedimentary basin or field.

Preparation of Reserves Estimates or Reserves Audits

The Final Rule does not require an independent third party to prepare a company’s reserve estimates or conduct a reserves audit. It will, however, require a company to provide a general discussion of the internal controls that it uses to assure objectivity in the reserves estimation process and disclosure of the qualifications of the technical person primarily responsible for preparing the reserves estimates or conducting the reserves audit (if the company discloses that such a reserves audit has been performed), regardless of whether the technical person is an employee or an outside third party.

If a company represents that a third party prepared the reserves estimate, conducted a reserves audit of the reserves estimates or performed a process review, the company must file a report of the third party as an exhibit to the relevant registration statement or report. This need not be the full “reserves report”, but would summarize the scope of the work performed by, and conclusions of, the third party, and the proposed contents of such reports would mirror the guidance issued by the Society of Petroleum Evaluation Engineers regarding the preparation of such reports.

Properties Disclosure Requirement

The Proposed Rule would have required more detailed disclosure of the properties owned by oil and gas companies than the general description of properties and facilities currently required by Item 102 of Regulation S-K. However, in response to comments on this proposal, the Final Rule merely incorporates the existing Industry Guide 2 requirements, without revision, into Regulation S-K.

Drilling and Other Exploratory and Development Activities

As a corollary to the inclusion of unconventional resources in the definition of reserves, the Final Rule requires companies to discuss their exploratory and development activities regarding oil and gas resources that are extracted by mining techniques.

Discussion and Analysis for Registrants Engaged in Oil and Gas Activities

The Final Rule does not adopt as proposed a modification to Regulation S-K, which would have specified topics that a company should address as part of its MD&A. Rather, the Final Rule release itself contains added guidance that an oil and gas company should consider in preparing its MD&A. To the extent that any discussion or analysis of known trends, demands, commitments, uncertainties, and events that are reasonably likely to have a material effect on the company is directly relevant to a particular tabular disclosure required by new Subpart 1200 of Regulation S-K, a company may include that discussion or analysis with the relevant table, with appropriate cross-references, rather than including it in its general MD&A section.

Conforming Changes to 20-F

The Final Rule requires foreign private issuers to comply in Form 20-F with the same reserves disclosure requirements applicable to domestic issuers. However, a foreign private issuer will continue to be able to exclude disclosures about reserves and agreements if its home country prohibits such disclosure.

MJDS – Form 40-F Filers

The Final Rule does not impact Canadian issuers reporting under the Canada-U.S. Multi-Jurisdictional Disclosure System, except with respect to any required reconciliation of the issuer’s financial statements to U.S. generally accepted accounting standards under Item 18 of Form 20-F.

Impact on Accounting Literature

Prices Used for Accounting Purposes

The Final Rule departs from the Proposed Rule in revising the SEC's full cost accounting rules set forth in Rule 4-10(c) of Regulation S-X to use the same 12-month average price to estimate reserves for accounting purposes as for disclosure purposes (see **Year-End Pricing**, above). In the Proposed Rule, the SEC had proposed to retain the use of a single-day, year-end price for accounting purposes. This proposal, which would have effectively required companies to calculate reserves twice, using two different pricing assumptions – once for disclosure purposes and once for accounting purposes – was uniformly opposed by commenters.

The full cost accounting method permits certain oil and gas extraction costs to accumulate on a company's balance sheet subject to a limitation test or a "ceiling". Like reserve disclosures, these capitalized costs and the related limitation test are not fair-value based measurements. Because the change to the full cost accounting method would effectively eliminate the anomalies caused by the single-day, year-end price currently used in the limitation test, the Staff will eliminate portions of Staff Accounting Bulletin (SAB) Topic 12:D.3.c that permit consideration of the impact of price increases subsequent to the period end on the ceiling limitation test. In periods of rising oil and gas prices, these changes could result in ceiling test write-downs that would not have been required using the

single-day, year-end price. Conversely, in periods of declining prices, the changes to the full cost accounting rules could result in the deferral of ceiling test write-downs. Companies should discuss such situations, if material, particularly when pricing trends indicate the possibility of future write-downs, in the Management's Discussion and Analysis and, where appropriate, the notes to the financial statements.

Consistency with FASB and IASB Rules

The Staff is in the process of communicating with the FASB staff to align the standards used in FASB pronouncements with the Final Rule. The SEC will consider whether to delay the compliance date of the Final Rule amendments based on the progress of its discussions with the FASB and IASB.

Differing Capitalization Thresholds Between Mining Activities and Oil and Gas Producing Activities

Under current U.S. accounting guidance, costs associated with proven plus probable mining reserves may be capitalized for operations extracting products through mining methods, like bitumen. Under the Final Rule, bitumen extraction and operations that produce oil and gas through mining methods will be included under oil and gas accounting rules, which only permit capitalization of costs associated with proved reserves. Moreover, the mining guidelines do not provided specified percentages for establishing levels of certainty for proven or probable reserves for mining activities.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

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