

T O O U R F R I E N D S A N D C L I E N T S
M e m o r a n d u m



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SEC Updates Reporting Requirements for Oil and Gas Companies

The SEC recently published its final rule release (the “Adopting Release”)¹ announcing significant revisions to its rules governing disclosures by oil and gas companies. The oil and gas disclosure requirements were initially adopted in 1978 and 1982, and industry participants had been urging the SEC to amend its rules to bring the requirements into alignment with current industry practices. The new rules reflect efforts to modernize disclosure, increase comparability between companies and streamline information into a more useful format for investors. The following memorandum provides a brief summary of the most significant changes to disclosure requirements, including the following:

- Companies will be required to file as an exhibit short form reports summarizing the findings of any third parties used to prepare reserve estimates or audit reserves in their public filings;
- In addition to disclosing proved reserves, companies will have the option of disclosing probable and possible reserves to investors; and
- When calculating oil and gas reserves, companies will be required to use an average price based on the prior 12-month period instead of year-end prices, which often led to significant variations in reserves based on whether the price as of the year-end was higher or lower than the yearly average.

Companies must comply with the new disclosure requirements 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, 2009.² Early compliance with the new requirements is not permitted.

¹ The Adopting Release and the new rules are available on the SEC’s website at the following address: <http://www.sec.gov/rules/final/2008/33-8995.pdf>. The Adopting Release includes significant revisions to the definitions set forth in Rule 4-10 of Regulation S-X, codifies and updates the requirements of the SEC’s Industry Guide 2: Disclosure of Oil and Gas Operations as new Subpart 1200 of Regulation S-K and provides oil and gas companies guidance regarding the disclosures made in Management’s Discussion and Analysis of Financial Condition and Results of Operations.

² Form 20-F will be amended to require oil and gas foreign private issuers to provide the disclosures discussed below. Companies whose home country prohibits them from including disclosure regarding reserves and agreements will continue to be able to exclude the information from their filings. The new disclosure requirements will not apply for foreign private issuers under the Multi-Jurisdictional Disclosure System using Form 40-F that comply with NI 51-101 in Canada.

I. Codification of Industry Guide 2 and New Disclosure Requirements in Regulation S-K

a. Reserves Disclosure Tables

As part of the SEC's effort to improve the readability and comparability of disclosures among companies, companies will be required to provide several oil and gas disclosure items in tabular form.³ Companies will be required to show proved developed, proved undeveloped and total proved reserves by geographic area⁴ and final product (specifically, oil, gas, synthetic oil, synthetic gas or sales products of other non-renewable natural resources that are intended to be upgraded into synthetic oil and gas). Companies have the option of disclosing probable or possible reserves, but must disclose the relative uncertainty associated with those classifications. Companies will continue to be prohibited from disclosing in SEC filings estimates of oil and gas resources other than those classified as reserves, subject to certain limited exceptions. Several new definitions set forth in Regulation S-X establish the parameters of the information that must be included in these tables.

i. Definitions of Reserves

The new rules establish key definitions regarding reserves and reserve categories:

- **Reserves** – Reserves, which was previously undefined, is now defined as “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.”⁵
- **Proved Reserves** – Proved reserves is defined as those quantities which geological and engineering data can demonstrate with “reasonable certainty” to be recoverable from known reservoirs under existing economic and operating conditions.⁶
- **Probable Reserves** – Probable reserves is defined as reserves “that are less certain to be recovered than proved reserves but which, together with proved reserves, are as likely as not to be recovered.”

³ Companies will also have the option of including a reserves sensitivity table that provides estimates of reserves for each product based on different price and cost criteria. Companies including this table must also disclose the assumptions and price and cost schedules on which the alternate estimates are based.

⁴ The new rules include a definition for the phrase “by geographic area,” which will require companies to provide disclosure by individual country, by groups of countries within a continent or by continent, as appropriate for meaningful disclosure in the circumstances. With respect to reserve estimates and production figures, companies must disclose each country (or field in the case of production) that contains 15% or more of the company's proved reserves.

⁵ The new definition requires that the company have or reasonably expect to have (1) the legal right to produce or a revenue interest in the production of the oil and gas, (2) the installed means of delivering the oil and gas to the market, and (3) all permits and financing required to implement the project. Oil and gas resources are economically producible if the resource generates revenue that exceeds, or is reasonably expected to exceed, costs of operation.

⁶ The new rules define “reasonable certainty,” which can be established either through deterministic or probabilistic methods. The new rules establish alternative standards for the meaning of reasonable certainty under each method.

- **Possible Reserves** – Possible reserves is defined as additional reserves “that are less certain to be recovered than probable reserves.”

ii. Developed and Undeveloped Reserves

The new rules expand the definitions of “developed” and “undeveloped” reserves and clarify that these concepts apply to proved, probable and possible reserves. The definition of developed oil and gas reserves will include reserves at existing wells in which the cost of the required equipment is relatively minor compared to the cost of a new well. Developed reserves will also include reserves that can be expected to be recovered by extraction methods not involving a well if recovered through installed extraction equipment and infrastructure that are operational at the time of the reserves estimate.

With respect to the definition of undeveloped reserves, the new definition will allow companies to classify reserves in drilling units beyond immediately adjacent drilling units as undeveloped reserves if reasonable certainty of economic producibility can be established using reliable technology.⁷ The new definition only allows companies to classify reserves in undrilled locations as undeveloped reserves if a development plan has been adopted that indicates that the undrilled location is scheduled to be drilled within five years, unless the specific circumstances justify a longer time (such as projects that are expected to run for more than five years).

b. Disclosures Regarding Preparation of Reserve Estimates

Companies that disclose the use of a third party to prepare reserve estimates or conduct an audit of reserve estimates will be required to file the report by the third party as an exhibit to their filing. This is a significant change from the current rules, under which companies would typically only file the consent of the third party named in the filing. Recognizing that these reports are often long and detailed, the new rule allows companies to file a shorter form report summarizing the work and conclusions of the third party.⁸ Companies should begin to discuss this requirement with their third party auditors, who may want to institute new procedures or make changes to the terms of their engagement. A general discussion of the internal controls used in the reserve estimation process will also be required disclosure, including the qualifications of the technical person primarily responsible for overseeing the reserves audit.

c. Proved Undeveloped Reserves

Companies will be required to include narrative disclosure regarding (1) the total quantity of proved

⁷ The new rules also provide a broader definition of reliable technology. For companies that have not previously disclosed reserve estimates in an SEC filing or are disclosing material additions to reserve estimates, a concise summary will be required regarding the technology used to create the reserves estimates from material properties.

⁸ If the company’s disclosures are made in, or incorporated into, a registration statement, the company must also file the consent of third party as an exhibit. The rules set forth a number of items that must be included in the report, which are based on the Society of Petroleum Evaluation Engineer’s audit report guidelines. These include, among others items, the proportion of total reserves covered by the report and geographic area in which the covered reserves are located, the assumptions, data, methods and procedures used to conduct the audit, a discussion of primary economic assumptions and a discussion of inherent risks and uncertainties of reserve estimates. If the report relates to a reserves audit, it must also contain a brief summary of the third party’s conclusions with respect to the company’s reserve estimates.

undeveloped reserves at year end, (2) any material changes to proved undeveloped reserves (including the conversion of proved undeveloped reserves into proved developed reserves), (3) investments and progress made in converting proved undeveloped reserves to proved developed reserves (including capital expenditures), and (4) an explanation of reasons why any material amounts of proved undeveloped reserves in an individual field or country have remained undeveloped for five years or more after being disclosed as proved undeveloped reserves.

II. Additional Amendments to Key Definitions Under Regulation S-X

a. Pricing Methodologies

In an effort to increase comparability between companies' disclosures and help to mitigate the effects of short term price volatility and seasonality, the new rules change the pricing methodology used to determine the economic producibility of a reservoir (*i.e.*, a company can only count reserves that can be extracted on an economically profitable basis based on the price used in the formula). The methodology will change from a single-day, year-end pricing system to a 12-month average price, calculated as the unweighted average price of the first day of each month within the 12-month period prior to the end of the reporting period.⁹ This may result in significant changes to a company's reported reserves since the single-day, year-end system could result in large swings in reported reserves depending on whether prices were lower or higher on that day.¹⁰

b. Extraction of Bitumen and Other Non-Traditional Resources

The definition of "oil and gas producing activities" has been expanded to include the extraction of oil and gas from non-traditional and unconventional sources, rather than limiting the activities to traditional extraction sources, such as oil and gas wells. As a result, companies that are engaged in this type of extraction will now be subject to oil and gas disclosure requirements. The expanded definition includes extraction of oil and gas from shales and coal and the extraction of bitumen from oil sands. A company may only include coal and oil shales as oil and gas reserves if the company intends to convert the coal and oil shale into oil and gas.

III. Guidance for Management's Discussion and Analysis of Financial Condition and Results of Operations Disclosures

In the Adopting Release, the SEC published guidance on disclosure in MD&A for oil and gas companies. The guidance sets forth a list of topics that companies should address if the topic constitutes, involves or

⁹ For reservoirs for which prices are defined by contractual arrangements, companies should use the contractual arrangements instead of the 12-month average price.

¹⁰ The final rules align the SEC's disclosure and accounting rules so that the full-cost accounting rules for certain oil and gas extraction costs described in Rule 4-10(c) of Regulation S-X will also use the 12-month average pricing system. The SEC indicated it will communicate with the Financial Accounting Standards Board to encourage the alignment of their accounting standards with the new full-cost accounting rules.

indicates a known trend, demand, commitment, uncertainty or event that is reasonably likely to materially affect the company. The following topics were included:

- changes in proved reserves and probable and possible reserves (if disclosed), and the sources attributable to such changes, including changes that are the result of changes in prices, technical revisions and changes in the status of concessions held by the company;
- if there is a material addition to, or increase in, reserve estimates, the technologies used to establish the appropriate level of certainty for those changes;
- prices and costs, including the impact of prices and costs on depreciation, depletion and amortization;
- performance of wells that are currently producing, including water production from those wells and the need to use enhanced recovery techniques to maintain production from those wells;
- performance of any mining-type activities for the production of hydrocarbons;
- recent ability to convert proved undeveloped reserves into proved developed reserves, and, if disclosed, convert probable reserves to proved reserves and possible reserves to probable or proved reserves;
- minimum remaining terms of leases and concessions;
- material changes to any line item in the new tables required by the rules;
- potential effects of different forms of rights to resources (e.g., production sharing contracts) on operations; and
- geopolitical risks that apply to material concentrations of reserves.

While these are issues that would typically be addressed in MD&A, the SEC noted that the new disclosure requirements will result in a substantial amount of information appearing in tabular form and it may be more helpful to investors for companies to include the discussion of these issues close to the tables rather than in the general MD&A discussion. Appropriate cross-references should be provided.

* * *

The changes to the disclosure requirements discussed above are significant and it is important for oil and gas companies to closely review the new rules to understand what impact the changes will have on reserve disclosures going forward. Discussions with counsel and any reserve auditors should begin now in order to facilitate a smooth transition to the new requirements.

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