JONES DAY

JANUARY 2009

SEC MODERNIZES REQUIREMENTS FOR REPORTING OIL AND GAS RESERVES

On December 29, 2008, the United States Securities and Exchange Commission (the "SEC") issued a final rule adopting amendments to its oil and gas reporting requirements, which exist in their current form in Regulation S-K and Regulation S-X under the Securities Act of 1933 and the Securities Exchange Act of 1934, as well as Industry Guide 2. The amendments modernize and update the manner in which companies disclose their oil and gas reserves in SEC filings by taking into account significant changes in the oil and gas industry since the SEC's adoption of its original rules more than 25 years ago. The SEC's goal was to provide investors with more meaningful and comprehensive information on oil and gas reserves by aligning reporting requirements with current industry practices and technological advancements.

Companies are required to comply with the new reporting requirements on all registration statements filed on or after January 1, 2010, and all annual reports on Forms 10-K and 20-F for fiscal years ending on or after December 31, 2009. Filers may not adopt the new reporting requirements early. The SEC specifically delayed effectiveness of the new rules so that it could work with the Financial Accounting Standards Board (the "FASB") to resolve any differences between the new rules and the accounting standards that are currently in use for financial statement purposes. To ensure consistency between the two sets of rules, the SEC announced that it may delay the mandatory compliance date beyond January 1, 2010, if coordination with the FASB is delayed.

NEW REPORTING REQUIREMENTS

Adoption of 12 Month Average Pricing for Reserves Estimation. Companies are required to report proved oil and gas reserves that are economically producible under existing economic conditions. The current rules mandate that, in calculating economic producibility, the price used for existing economic conditions is the price on the last day of the year. The new rules require companies to use the unweighted average of

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the price on the first day of each month for the 12 months preceding the end of the company's fiscal year. For example, if a company's fiscal year is the calendar year, then the company will use the prices on the first day of each month from January through December. If a contractual arrangement defines pricing, then companies should use the contractual price but without taking into account any price escalations based upon future conditions.

This change is intended to reduce the effects of short-term volatility and seasonality in the market while enhancing comparability between companies. The SEC specifically chose historical prices instead of future prices or forecasts because its goal is to provide investors with information about the quantity of a company's reserves, not their fair market value. This information should enable investors to compare the business prospects of various companies on a more objective level.

Inclusion of Probable and Possible Reserves in Reportable Reserves. The current rules limit reportable reserves to those that are classified as "proved" and does not permit companies to disclose reserves that are classified as "probable" or "possible." This rule is more stringent than the standards adopted by many other countries, which permit companies to report the broader categories of reserves. U.S. companies have argued for some time that this disparity places them at a significant disadvantage in the global capital markets compared to their international competitors. Likewise, investors have complained that without information regarding "probable" and "possible" reserves, it is difficult for them to evaluate a company's capital expenditure decisions and development plans. In response to these concerns, the SEC is relaxing the current restrictions to give companies the option to report "probable" or "possible" reserves using the following standards: A) Probable reserves, in combination with proved reserves, must have at least a 50 percent chance of being recovered or must be as likely to be recovered as not to be recovered; and B) possible reserves, in combination with proved and probable reserves, must have at least a 10 percent chance of being recovered or might only be recovered under more favorable circumstances than are likely to occur.

Expansion of the Definition of "Oil and Gas Producing Activities." Currently, companies are only permitted to include in "oil and gas producing activities" sources of oil and gas that involve extraction by "traditional" oil and gas wells. Thus, unconventional resources such as oil sands, shales, and other nonrenewable natural resources have previously not been included in any reserve categories. Over the last 25 years, however, the development of unconventional resources has become increasingly common due to technological advancements and improved methods of extraction. Instead of focusing on the method of extraction, the new rules focus on the final product. The revised definition of "oil and gas producing activities" will now include the extraction of saleable hydrocarbons 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. However, companies will be required to report separately traditional and synthetic final products in their disclosures since nontraditional extraction methods involve different economics and company resources and are therefore evaluated differently by investors.

Use of "Reliable Technology" to Meet "Reasonable Certainty" Standard to Prove Reserves. Oil and gas reserves are "proved" if their economic production is reasonably certain. To add clarity, the new rules define "reasonable certainty" to mean a "high degree of confidence that quantities will be recovered." The SEC also defines "high degree of confidence" to mean a quantity that is "much more likely to be achieved than not."

The current rules require companies to use specific limited standards, such as actual production and flow tests, to meet the "reasonable certainty" standard to prove its reserves. To accommodate other sources of information and changes in technology, the new rules will permit companies to use any "reliable technology" to estimate their reserves. Reliable technology will include any technology that has been field-tested and has demonstrated consistency and repeatability in the formation being evaluated or in an analogous formation. Any proprietary technology or combination of technologies can be used once a company is able to establish and document the reliability of the technology.

In conjunction with the expanded definition of "oil and gas producing activities," the ability to use any reliable technology may enable companies to report substantially higher reserves, particularly reserves of unconventional sources of oil and gas.

Broader Definition of "Proved Undeveloped Reserves." The new rules expand the proved undeveloped reserves ("PUDs") a company can report. To classify reserves as PUDs under the current rules, companies apply a "reasonable certainty" standard for reserves in drilling units immediately adjacent to the drilling unit containing a producing well. However, they must apply a "certainty" standard for reserves in non-adjacent drilling units. The new rules not only apply the "reasonable certainty" standard to all proved reserves but also permit companies to report PUDs regardless of their location. Furthermore, companies will be able to use the new "reliable technology" standard, instead of the current actual production standard, to determine the quantity of PUDs they report.

Finally, the final rule also removes the five-year time limit on maintaining PUDs that remain undeveloped absent "unusual circumstances." Instead, the new rules permit companies to continue to report PUDs that remain undeveloped due to "specific circumstances." However, the new rules will require the company to disclose why the PUDs remain undeveloped (*e.g.*, if a pipeline or processing facility needs to be built first).

Optional Disclosure of Price Sensitivity. The new rules permit companies to include in their disclosures an additional "reserves sensitivity table" to provide additional information to investors. A company will be permitted to disclose any sensitivity its oil and gas reserves estimates may have to price fluctuations in different market scenarios or test cases selected by the company. If a company opts to include alternative scenarios, it must disclose the price and cost schedules and underlying assumptions supporting its alternative reserves estimates. If included, this optional disclosure should provide additional useful information to investors during times of high volatility in the commodity markets.

Disclosure by Geographic Area. Under the current rules, companies report the location of their reserves in widely varying ways, including by hemisphere and by continent. The new rules require companies to disclose production by individual country, groups of countries within a continent, or by continent, as appropriate. A company must disclose each individual country in which 15 percent or more of its total proved reserves are located, subject to two exceptions. First, if the disclosure would effectively reveal a particular field, which could cause the company competitive harm, the company would not be required to disclose the individual country. Second, if the law of the particular country prohibits disclosure of particular fields, the company would not be required to disclose any production in that country if the disclosure would effectively disclose a particular field.

Internal Control and Qualification Disclosures. The new rules require companies to provide a general description of their internal controls for ensuring objectivity in their reserves estimation process and the qualifications of the technical person primarily responsible for the estimations, whether that person is an employee or a third party. If a company uses a third party to prepare the estimate or audit the estimate, it must include in its filing a report prepared by the third party. The third-party report is a short-form report that must discuss, among other things, the scope of the work performed by the estimating party, together with the estimating party's conclusions or analysis and relevant methodologies and assumptions.

SUMMARY AND CONCLUSIONS

The new SEC reserve reporting requirements are intended to benefit both oil and gas companies and their investors by recognizing technological developments in the exploration and development of reserves, as well as advances in the evaluation of reserves. The failure to account for these matters has left industry analysts and investors using the indirect disclosures made by companies elsewhere in their filings to guess the impact on the companies' valuations. Once the new rules become effective, it may take some time for analysts and investors to adjust to the new disclosures, since oil and gas companies may report significantly higher reserves even when the underlying facts have not changed. While this adjustment is taking place, it will be interesting to see what impact, if any, it has on the level of M&A and capital markets activity for oil and gas companies.

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