

SEC Adopts Major Revisions to Oil and Gas Disclosure Requirements

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On December 31, 2008, the U.S. Securities and Exchange Commission adopted major revisions to its rules governing disclosures that companies engaged in oil and gas activities make in the documents they file with the Commission. The revisions also conform the full cost accounting rules to the revised disclosures. Further changes in accounting rules will also be required, and the Commission will take those up with the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). Subject to the outcome of those discussions, the new rules will be effective in 2010 – i.e., for registration statements that are filed on or after January 1, 2010 under the Securities Act of 1933 and for annual reports on Forms 10-K or 20-F for fiscal years ending on or after December 31, 2009.

The Commission's effort to revise the existing rules began with the issuance of a Concept Release in December 2007. Based on that release and the resulting comments, the Commission proposed new rules in June 2008. The proposed rules also engendered extensive comment.

In adopting the new rules the Commission recognized that its prior rules, adopted more than 25 years ago, had not kept pace with subsequent significant developments in the oil and gas industry. These changes included major advances in the technology used to assess oil and gas reserves, substantially increased volatility in oil and gas prices, the rapidly growing importance of non-traditional sources of oil and gas and the increasing geographic diversification of the industry (including significant growth both in the number of major non-U.S. oil and gas companies that file reports with the Commission and in the percentage of U.S. oil and gas companies' reserves that are located outside the United States).

The principal changes under the new rules are listed below:

- **Pricing:** The new rules change the pricing methodology for both reserves disclosure and accounting purposes to a 12-month average price, calculated based on the first day of each month, instead of the single-day period-end price.

- **Non-traditional resources:** The new rules include non-traditional resources, such as bitumen from oil sands and oil and gas from coal and shale, as oil and gas activities. Currently, they must be disclosed as mining activities.
- **Newer technologies:** The new rules permit determination of reserves based on newer technologies (other than just actual production or flow tests), so long as such technologies are empirically demonstrated to be reliable indicators of reserves volumes.
- **Deterministic and probabilistic methods:** The new rules permit the calculation of reserves estimates using both deterministic and probabilistic methods, as well as the inclusion of analogous reservoirs in reserves calculations.
- **Consistency with PRMS:** The new rules generally harmonize the definitions used in the Commission's oil and gas related disclosure rules with those used in the Petroleum Resources Management System (PRMS) developed by the Society of Petroleum Engineers (SPE) and other major industry organizations.
- **Reasonable certainty:** A number of new definitions are included, including a definition of "reasonable certainty" for reserves determinations. This definition follows the PRMS definition and provides that for probabilistic methods reasonable certainty requires at least a 90% probability that quantities recovered will equal or exceed the estimate. The definition also contains an "elaboration," which is consistent with the staff's prior position, to the effect that reasonable certainty embodies the concept that estimated ultimate recovery is much more likely to increase or remain constant than to decrease over time.
- **Undeveloped reserves:** The definition of undeveloped proved reserves changes the "certainty" standard for non-adjacent undeveloped reserves to a "reasonable certainty" standard.
- **Probable and possible reserves:** The Commission has abandoned its long-standing prohibition on disclosure of probable and possible reserves in Commission filings, and the new rules permit but do not require such disclosure. The terms probable and possible reserves are now defined, and the definitions are consistent with PRMS.
- **Codification of Guide 2:** The Commission eliminated the oil and gas related disclosure requirements previously appearing in Industry Guide 2 and codified those requirements in new Subpart 1200 of Regulation S-K.

- **Expansion of oil and gas disclosure:** New Subpart 1200 imposes several new disclosure requirements relating to reserves, including principally the following:
 - more detailed geographic breakdowns of reserves information;
 - technologies used in estimation of reserves;
 - registrants' internal controls over the reserves estimation process;
 - the qualifications of the technical person at each registrant who is primarily responsible for reserves estimation; and
 - the filing of third party reports comprising reserves audits or process reviews, if the issuer represents that a third party prepared or audited the reserves estimates or conducted a process review. The filed report can be a summary rather than the full report, and it must (in the case of a report on a reserves audit or third party preparation of a reserves estimate) contain specified information. In addition, where a report is included in or incorporated into a Securities Act registration statement, the third party must file a consent and is an "expert" for Securities Act purposes.
- **MD&A guidance:** The adopting release provides Commission interpretive guidance with respect to management's discussion and analysis (or, in the case of foreign private issuers, the operating and financial review).
- **Foreign private issuers:** The special oil and gas disclosure rules for foreign private issuers are eliminated; thus those issuers will be subject to the same requirements as U.S. domestic issuers. This change does not affect Canadian issuers that file with the Commission pursuant to the Multi-Jurisdictional Disclosure System.

Some of the principal issues raised by the new rules are described in greater detail below.

Pricing

As mentioned above, the Commission changed the pricing methodology used to determine the economic producibility of reserves to use a 12-month average price, calculated based on the first day of each month within the reporting period, instead of the current single-day period-end price. The 12-month average price is to be used under both the disclosure rules, where a company may only report economically producible reserves, and

the accounting rules, where, for example, price is a key factor in determining whether costs of acquisition, exploration and development of reserves are expensed or capitalized.

This change addresses criticism that the single-day period-end price is not the preferable price to establish economic producibility of reserves since it is particularly subject to volatility and seasonality. Thus, it is expected that a 12-month average price will produce improved reserves estimates while maintaining comparability. The Commission acknowledged that historical prices are less useful than expected future prices in determining the fair value of a company's reserves. The Commission believes, however, that reserves estimates are intended to permit comparison of volumes and not the fair value of reserves. In addition, using future prices could require subjective judgments and result in diminished comparability due to differing assumptions.

As the recent substantial changes in oil prices demonstrate, price volatility leads to uncertainty and unintended consequences for disclosure and financial statements regardless of the pricing methodology used. This affects not only the value of the reserves but also the existence of economically producible reserves. The new rules permit, but do not require, companies to provide a sensitivity analysis table to address this issue.¹ The Commission also reminded companies in the adopting release that Item 303 of Regulation S-K for domestic companies (the "management's discussion and analysis" section) and Item 5 of Form 20-F for foreign companies (the "operating and financial review" section) require discussion of known trends and uncertainties, which may include changes in prices and costs. In addition, companies should also consider whether to address price volatility risks in the form of risk factors. To determine the scope of the necessary disclosure, the standard a company should apply is whether the information it provides contains an untrue statement of a material fact or omits to state a material fact necessary to make it not misleading.²

¹ Item 1202 of New Subpart 1200 to Regulation S-K. The new rule includes a form for the table but does not specify whether the form is mandatory for companies opting to provide the disclosure. Since the disclosure is optional, we believe that companies should be permitted to disclose the information in the format they deem most appropriate.

² See Sections 11 and 12(a)(2) of the Securities Act and Rules 10b-5 and 12b-20 under the Securities Exchange Act of 1934.

Voluntary disclosure of probable and possible reserves

The current rules prohibit the disclosure of any reserves estimates other than proved reserves. The new rules permit, but do not require, the disclosure of probable and possible reserves and adopt new definitions for these terms. The new definitions are largely consistent with PRMS definitions.

Under the current rules oil and gas companies have widely disclosed amounts of probable and possible reserves by means other than through filings with the Commission, including through press releases and on Internet websites. The amendment to the rule recognizes this market practice and the fact that investors seem to find this information helpful in assessing a company's reserves position. It is unclear whether this change to the rule will in fact cause companies to disclose probable and possible reserves in filings with the Commission. Many commenters opposed this disclosure and raised the issue of potential liability that may arise from including such information in Commission filings. While liability issues might not be dispositive in the context of necessary or useful communications with investors and the market, in this case issuers have successfully followed the widely established market practice of disseminating this information outside Commission filings. There may thus be little incentive for companies to change their practice. Underwriters will also be exposed to heightened liability if a company includes, or incorporates by reference, probable or possible reserves information in Securities Act filings. As a result, they may also play a role in the development of any new disclosure practice, including by developing appropriate due diligence practices in connection with this information.

Compliance Date, Early Adoption

Compliance with the new rules will be mandatory for Securities Act registration statements that are filed on or after January 1, 2010 and for annual reports on Forms 10-K or 20-F for fiscal years ending on or after December 31, 2009. The adopting release indicates, however, that action by the FASB and the IASB will be needed to harmonize certain aspects of the applicable oil and gas accounting standards with the Commission's new rules, and that the compliance dates could be postponed if necessary to permit the implementation of those changes.

The adopting release also specifically states that companies may not elect to follow the new disclosure rules prior to the effective date, on the grounds that early adoption by some but not all affected companies would undermine comparability of information among companies in the oil and gas sector. A number of companies have inquired of the Commission whether exceptions will be made to permit companies to adopt at least some aspects of the new rules in their filings with the Commission prior to the effective date, in

particular the adoption of the new pricing mechanics. To date, the Commission's staff has indicated that there will be no exceptions permitting early adoption of the new rules.

The requirement to continue to follow the current rules, including the pricing rules, does not directly address the question of whether supplemental or optional disclosure of additional information (including information as to price sensitivity or reserves) is permitted. In our view, the *supplemental* disclosure of information should be permitted in filings with the Commission, subject to Rules 10b-5 and 12b-20 under the Securities Exchange Act, except to the extent that such disclosure is expressly prohibited by the current rules, as for example in the case of the prohibition on disclosure of unproved reserves. Indeed, the Commission in the release adopting the new rules suggests there are circumstances where additional disclosure of this sort might be required. (The December 31, 2008 spot price for Brent crude oil quoted by the Intercontinental Exchange (ICE) was \$39.53 per barrel, as compared to the 12-month trailing average of approximately \$100 per barrel.)³ Nonetheless, we understand that the current view of the Commission's staff is that the existing rules prohibiting the disclosure of any reserves in Commission filings other than proved reserves would prohibit the supplemental quantitative disclosure of any reserves estimates that would not qualify as "proved" according to the current rules, thus also prohibiting the disclosure of reserves estimates using a different pricing methodology. This view would appear not to extend to qualitative disclosure addressing the impact that the new rules, including the new pricing methodology, would have on the company's reserves. If this view holds, we would expect issuers that conclude that quantitative information is useful to investors to disseminate it through means other than Commission filings, as they have done effectively under the existing rules with information regarding unproved reserves. Such a development would of course make Commission filings relatively less useful to investors and the market.

Accounting Issues

Both the disclosure rules and the full cost method accounting rules will use the 12-month average price, calculated using the price of the first day of each month during the reporting period.⁴ The new rule will also apply to companies that follow the successful efforts method, since FASB Statement of Financial Accounting Standards ("SFAS") No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, as amended, refers to Regulation S-X definitions. This change will allow consistency between the new

³ On January 27, 2009, the price was \$43.64 per barrel.

⁴ Rule 4-10(a)(22) and Rule 4-10(c)(8) of Regulation S-X. In the proposing release, the Commission proposed changing the disclosure rules to a 12-month average price, while maintaining the use of a single-day period-end price in the accounting rules. All commenters addressing this issue opposed the use of different standards.

reserves disclosure requirements and the accounting presentation of reserves. The Commission also clarified that the pricing change should be applied prospectively only and does not require retroactive revision. (Similarly, the Commission indicated that accounting changes as a result of non-traditional resources being accounted for under oil and gas accounting rules and not mining industry rules should be applied prospectively only and do not require retroactive revision.)

Nonetheless, the new rules are different from the existing oil and gas accounting requirements in important respects, including the fact that SFAS No. 69, *Disclosures About Oil and Gas Producing Activities*, still requires supplemental disclosures based on a single-day end-of-period price. If the FASB does not amend the relevant accounting pronouncements, companies would be required to prepare two sets of reserves disclosures. Uncertainties also exist in connection with IFRS. The IASB is developing a new oil and gas standard, and there is no assurance that it will be consistent with the Commission's new rules. The Commission acknowledged in the adopting release the importance of providing consistency of standards and stated that it is communicating with the FASB and the IASB on these matters.

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We will separately publish a more detailed analysis of all the amendments introduced by the new rules. Please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under "Capital Markets" under the "Practices" section of our website (<http://www.clearygottlieb.com>) if you have any questions.

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