


ENERGY ALERT



Since Royal Dutch Shell announced a 20 percent downward revision in its proved oil and gas reserves, the U.S. Securities and Exchange Commission (SEC), foreign regulators and, of course, U.S. plaintiffs' lawyers have besieged energy companies worldwide. The developments at Shell and other energy companies, highlighted by regular and in-depth press coverage, have caused many to lose confidence in reported reserves figures. Not just regulators and the media, but institutional investors, analysts, audit committees, rating agencies and independent accountants are asking tougher questions and clamoring for reassurance that management has accurately calculated and disclosed oil and gas reserves. In response, a number of oil and gas companies have taken steps to review, reconsider and, in certain cases, restate their proved reserves.

The SEC has confirmed that it will review all oil and gas companies whether or not there is evidence of wrongdoing. In fact, the majority of cases are likely not the result of corporate malfeasance but of inadequate, or inconsistently implemented, procedures; misinterpretations of complicated, and in some cases outdated, regulations; or improper reconciliation of SEC requirements with international or home country disclosure obligations.

Possible "red flags" include:

- lack of third-party or independent internal review of proved reserves estimates
- management bonuses directly or indirectly linked to proved reserves
- reserves conflicting with other companies' reporting reserves in the same property
- significant proved reserves booked in deepwater fields or based on advanced technology.

To identify previously undetected issues and to avoid problems going forward, senior management should promptly initiate an in-depth review of reported reserves and the procedures for calculating and disclosing proved reserves. The following five-part action plan — which we believe represents a developing standard for the industry — is designed to help organize this process:

- (1) Conduct a thorough internal audit of reserves disclosure and of internal procedures for calculating reserves.
- (2) "Expertize" proved reserves figures through independent engineering firm investigation and verification.

- (3) Establish or strengthen existing internal auditing of reserves and require involvement of personnel outside of the line of business who report directly to independent directors.
- (4) Retain independent accounting and legal advisors to review reserves booking policies and procedures and to make appropriate recommendations.
- (5) Develop and implement formal procedural guidelines for future disclosure consistent with SEC requirements (e.g., sub-certifications from responsible personnel and a checklist of clear criteria for recognizing reserves).

The following Alert maps out a practical, proactive strategy for senior management at oil and gas companies to take the initiative with respect to the foregoing matters.

RESTORING CONFIDENCE IN PROVED OIL & GAS RESERVES: A PRACTICAL APPROACH

Since Royal Dutch Shell's January announcement of a 20 percent downward revision in its proved oil and gas reserves,¹ the SEC, foreign regulators and, of course, U.S. plaintiffs' lawyers have besieged energy companies worldwide. The developments at Shell and other energy companies, brought to the fore by regular and in-depth press coverage, have caused many analysts and investors to lose confidence in reported reserves figures. This, in turn, has had a negative impact on the stock market valuations of many oil and gas producers, despite historically high oil prices. Institutional investors, audit committees, rating agencies and independent accountants are asking tougher questions and clamoring for reassurance that management has accurately calculated and disclosed oil and gas reserves. There are compelling legal and business reasons dictating that energy company executives should take proactive steps to review and improve their procedures for calculating and disclosing proved reserves.

The heightened scrutiny² of reserves disclosure has already caused a number of domestic and international oil and gas companies to review and restate their proved reserves. The SEC has now indicated that it will systematically review the public disclosure of energy companies disclosing oil and gas reserves.³ This announcement is in accordance with its new policy of opening broad investigations into entire industries and sectors when evidence of problems surface at a single company, even if there is no proof of industry-wide wrongdoing, which is ironically labeled "wildcatting." Add to this the provisions of the Sarbanes-Oxley Act of 2002 directing the SEC to conduct more frequent reviews of periodic reports (including annual reports on Form 10-K or 20-F), and oil and gas companies should expect this year's filings and other public disclosure to be reviewed closely.⁴

Although corporate malfeasance may, in a small number of cases, be the cause of non-compliant proved reserves estimates, the majority of cases are likely the result of companies (i) misinterpreting complicated, and in some cases outdated, regulations, (ii) lacking adequate (or failing to properly implement) booking, auditing or disclosure procedures or (iii) failing to properly reconcile SEC requirements with international or home country disclosure obligations. All of these are factors that management can address. Because of the increasing regulatory scrutiny, rising threat of litigation and growing demands for reassurances from management, it is important for senior executives to focus on this issue with some urgency.

¹ See Royal Dutch Shell, January 9, 2004, Press Release, "Proved reserve recategorisation following internal interview: No material effect on financial statements," available at <http://www.shell.com>. See also Cummins, Warren & Schroeder, "Shell Cuts Reserve Estimate 20% as SEC Scrutinizes Oil Industry," THE WALL STREET JOURNAL (Jan. 12, 2004), and Hoyos, "Life of Shell Reserves Cut by Three Years," FINANCIAL TIMES (London Edition I) (Jan. 12, 2004) at p. 23. Shell has, as of the date of this writing, announced two subsequent cuts in its reserves estimates. The most recent, announced on April 19, reduces reserves amounts as of the end of 2002 by 22 percent. Shell has also announced that it will be reducing the amount of reserves it had originally planned to book for 2003. See Cummins, "Shell Cuts Reserves Again; Finance Chief Steps Down," THE WALL STREET JOURNAL (Apr. 19, 2004), viewed at <http://online.wsj.com> on April 19, 2004.

² Since January of this year, several major petroleum companies have received SEC inquiries regarding their reserves calculations, and both Shell and El Paso (who also recently slashed reserves estimates) have been hit with shareholder suits so far — in one suit against Shell, the plaintiffs are seeking \$5 billion. The claim against El Paso accuses El Paso and its senior managers of "issuing materially false and misleading statements" regarding their financial results and reported reserves. See "Shellshocked," THE ECONOMIST GLOBAL AGENDA (Mar. 10, 2004), viewed at <http://economist.com> on April 15, 2004, and Davis, "Reserves Haunt El Paso, Shell," TheStreet.com (Feb. 20, 2004), viewed at <http://thestreet.com/stocks/melissa-david/10144727.html> on April 15, 2004.

³ See Soloman, "SEC Expands Its Sleuthing To Full Sectors," THE WALL STREET JOURNAL (Mar. 18, 2004) at C1.

⁴ Section 408 of the Sarbanes-Oxley Act mandates SEC review of all companies filing reports at a minimum once every three years.

We recommend that clients in the upstream oil and gas industry initiate an in-depth review of their procedures for calculating and disclosing proved reserves. Based on the findings of the review, management should act promptly to correct any procedural shortcomings and address any potentially non-compliant bookings. It is important that the review be thorough and careful in order to avoid the embarrassment, not to mention the potential liability, associated with revising reserves disclosure multiple times.

To highlight key issues and underscore the importance of undertaking a review, we have prepared a list of questions that can help identify potential “red flags” requiring prompt remedial action. Companies should carefully consider these questions and their answers.

1. Have your proved reserves been subjected to an independent third-party review?
 - If not, do you have a functioning internal audit team?
 - Have your internal audit procedures been reviewed by independent advisers?
2. Are your internal procedures for calculating and disclosing reserves subject to varying interpretations or in practice applied differently for different properties?
3. Are there any indications of staff uncertainty about responsibility for reserves calculation and disclosure or related internal reporting?
4. Have you discussed your procedures for calculating and disclosing reserves with your independent auditors?
 - Have you had disagreements with, or received notices from, auditors that any previously issued financial statements should not be relied upon?
5. Are management bonuses, directly or indirectly, linked to proved reserves?
6. Do you hold interests in oil and gas properties for which other companies have restated their proved reserves?
7. Do your proved reserves bookings conflict with the proved reserves estimates of other companies with interests in the same oil and gas properties?
8. Do you report significant proved reserves in deepwater fields, on the basis of advanced technology,⁵ or from oil sand or unconventional gas assets, or report a large percentage of your proved reserves from one property?
9. Do you use proved probable reserves as a basis for depreciation and abandonment under non-U.S. generally accepted accounting principles? Are any of your proved undeveloped reserves (PUDs) more than five years old?
10. Are any of your proved reserves attributable to product sharing contracts or production sharing agreements (PSAs)?

⁵ In response to growing pressure on the SEC to acknowledge the effectiveness of newer technologies for deepwater fields, such as seismic surveys, the SEC recently agreed that reserves proved in deepwater fields in the Gulf of Mexico in reliance on a combination of open-hole logs, core samples, seismic surveys and wireline sampling could be included in companies’ proved reserves. The SEC specifically limited this exception to operations in the Gulf of Mexico, however. See *Letter to Companies with Oil and Gas Operations in the Gulf of Mexico*, SEC Letter from H. Roger Schwall, Assistant Director, Apr 15, 2004, viewed at <http://sec.gov/divisions/corpfin/guidance/oilgasltr04152004.htm> on April 26, 2004.

We recommend that oil and gas companies implement a five-part action plan in order to ensure the adoption, implementation and maintenance of adequate reserves calculation and disclosure procedures and to address any specific concerns highlighted by the questions above. While companies may differ from one another in important respects, including organizational structure, the following steps are appropriate for a wide variety of oil and gas companies, both in the United States and overseas, and, we believe, represent a developing standard for the upstream oil and gas industry:

1. Conduct a thorough internal audit of prior and currently planned public disclosures regarding proved reserves and internal procedures for calculating such reserves.
2. “Expertize” proved reserves figures through independent engineering firm investigation and verification.
3. Establish or strengthen existing internal auditing of reserves and require involvement of personnel outside of the line of business who report directly to independent directors.
4. Retain independent accounting and legal advisors to review reserves booking policies and procedures and to make appropriate recommendations.
5. Develop and implement formal procedural guidelines for future disclosure consistent with SEC requirements.

The benefits of implementing these measures extend well beyond the primary goal of ensuring quality control of reserves calculation and disclosure. Additionally, these steps will help to:

- **Facilitate verification of disclosure controls and procedures and internal controls over financial reporting.** The Sarbanes-Oxley Act imposes new disclosure requirements with respect to internal controls over financial reporting and disclosure controls and procedures. Effective for fiscal years ending in 2005 (2004 for accelerated filers), companies registered with the SEC will be required to include in their annual and periodic reports additional disclosure on their evaluations of these controls, including a management report on internal controls, as well as an attestation from their independent auditors with respect to management’s findings in the report.
- **Minimize liability of certifying officers.** The Sarbanes-Oxley Act requires chief executive and chief financial officer certifications as to the accuracy of information contained in a company’s annual and periodic reports, and imposes significant liabilities with respect to this requirement.
- **Bolster investor confidence and provide management with credible support.** Especially in the current environment, management needs to be in a position to defend proved reserves numbers to a company’s audit committee, independent auditors, the SEC and, equally importantly, to a company’s institutional shareholders.

SEC RULES REGARDING DISCLOSURE OF OIL AND GAS RESERVES

Proved reserves estimates are one of the single most important economic indicators for oil and gas companies. The difficulties that complicate the calculation of proved reserves are not new, nor are the challenges faced in developing effective internal controls and reporting procedures. One factor underlying both of these objectives is the overlap between engineering, legal and accounting priorities and restraints. Oil and gas companies that file periodic reports or registration statements with the SEC are subject to the myriad reporting rules and requirements contained in

Regulation S-K, Regulation S-X, FAS 69, and Form 20-F (for foreign filers) or Form 10-K (for domestic filers). Domestic filers are subject to additional requirements under the SEC's Industry Guide No. 2 (Disclosure of Oil and Gas Operations). Although not technically required, it is an established market practice among foreign oil and gas companies (especially those interested in attracting U.S. investors) to provide Guide 2 disclosure. Foreign oil and gas companies and U.S. companies listed on foreign stock exchanges must also simultaneously comply with foreign disclosure requirements, which often permit or require disclosure of reserves information inconsistent with SEC rules.

Disclosure of reserves in SEC filings is limited to proved reserves

It is not enough to know that there is oil or gas in the ground. It is equally important to estimate, with some degree of certainty, how much of it is there, demonstrate a commercially viable means of extracting it, and identify a willing and able buyer. Therefore, the amount of reserves a company can report depends in large part on its economic productivity, which in turn is significantly influenced by technology and the price of oil and gas. If this criteria cannot be met to the SEC's satisfaction, reserves cannot be included in SEC filings. The difference between proved versus probable reserves can have a huge impact on a company's balance sheet and create significant disparity between a company's publicly reported reserves and internal estimates. For example, ExxonMobil reportedly has 22 billion barrels of proved reserves, but another 50 billion barrels of probable reserves.⁶

Companies registered with the SEC that have material oil and gas operations are required to furnish information with respect to proved oil and gas reserves. In general, a company may include as proved reserves only those estimated quantities of hydrocarbons that a company has demonstrated by actual production or by conclusive formation tests to be economically and legally producible under existing economic and operating conditions.⁷

However, in reality, reservoir engineering is a subjective process of estimating underground accumulations of oil and gas that cannot be measured precisely. As a result, substantive and formal compliance with the various disclosure requirements is far from straightforward, and requires navigating a minefield of inadvertent violations. The accuracy of any reserve estimate is a function of the quality of available data, engineering and geological interpretation, and professional judgment. The defining characteristics of proved reserves necessarily require a company to predict future production based on current conditions and certain assumptions. Other different, but equally valid, assumptions might lead to significantly different results. Reserve estimates are often different from the quantities of oil and gas that are ultimately recovered. Oil and gas companies generally caution investors against unwarranted reliance on their reserves estimates and related calculations, such as PV-10 calculations, but companies must be careful to ensure that such cautionary language does not dilute the "reasonable certainty" with which a company must be able to estimate the economic recoverability of its proved reserves.⁸

The gap between the SEC's concept of proved reserves and what, in practice, may be economically recoverable is enlarged by the development of newer technologies. For example, the reservoir information provided by 3-D seismic

⁶ See Fawcett, "Shell's Slippery Slope," BBC News (Mar 18, 2004), viewed at <http://newsvote.bbc.co.uk> on April 15, 2004.

⁷ Rule 4-10(a) of Regulation S-X defines proved oil and gas reserves as "the estimated quantities of crude oil, natural gas, and natural gas liquids which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions, i.e., prices and costs as of the date the estimate is made. . . . Reservoirs are considered proved if economic productivity is supported by either actual production or conclusive formation test."

⁸ See SEC Comment Letter dated Aug 22, 2002, in response to an S-4 filing by Newfield Exploration Company.

data and modular formation dynamic tests can significantly increase the amount of reserves estimated to be economically recoverable from a reservoir, but does not necessarily fall within the scope of a “conclusive formation test” as interpreted by the SEC.⁹

Internal procedures are a primary focus of SEC review and comments

Empirically, in reviewing filings submitted by oil and gas companies, the SEC has focused its review of, and comments related to, reserves on the following items:

- the criteria and methodology a company relies on in the calculation of its proved reserves
- the use of additional supporting data and/or explanation with respect to determinations of economic productivity
- a company’s internal review process of reserve calculations, and
- whether the company has implemented an independent review process.

RECOMMENDED FIVE-PART ACTION PLAN

We recommend that oil and gas companies implement the following five-part action plan to help organize a comprehensive review of proved reserve figures and to ensure the adoption, implementation and maintenance of adequate reserves calculation and disclosure procedures.

FIRST: Conduct a thorough internal audit of prior and currently planned public disclosure regarding proved reserves bookings and reserves management system¹⁰ or other internal procedures for calculating reserves. The review should focus, at least initially, on proved reserve disclosures for the last two years, and should include a comprehensive review of all trigger events, accounting, testing, and any management discussion and analysis (and the underlying data thereof) related to the booking of proved reserves. While it ultimately may be necessary to restate disclosed proved reserves in individual cases, companies should consider carefully, including in consultation with outside counsel, whether restatement is warranted. If so, companies should take care to ensure the restatement is performed correctly and disclosed appropriately. This review should be conducted as soon as possible. For example, in light of the upcoming filing deadline for 20-F annual reports, foreign filers should work toward including material findings resulting from the review in their upcoming annual report. We recommend that companies take the following steps prior to, or in conjunction with, initiating their review:

- Establish an **internal reserves review team (RRT)** to conduct the audit/review of current and recent reserves bookings and public disclosure (such as 10-Ks, 20-Fs, disclosure documents used to sell securities, etc.). This team should have the authority and budget to conduct its review free of institutional pressure to reach specified conclusions. This team should have at least one representative from each of the company’s accounting, engineering and legal departments. The RRT should exclude the CEO and CFO of the company;

⁹ The SEC has recently expanded the testing methods it will recognize for proved reserves in deepwater Gulf of Mexico, but specifically limits this exception to the Gulf of Mexico. See note 5 above.

¹⁰ Key elements of an effective Reserves Management System are: technical analysis of reserves using SEC-recognized testing methods, economic calculations, reserves classifications, documentation of estimates, reserve review team and management review and approval of reserve estimates, and an external audit of reserve estimates.

- Particular attention should be given to any of the following that are applicable:
 - reserves booked in any field where production has significantly declined
 - any particular geographic areas where a substantial percentage of the company's proved reserves have been booked
 - reserves booked in areas for which license periods are due to expire prior to, or near, the time when currently booked reserves are expected to be produced
 - any proved reserves included in a prior public filing that (i) were not proved using a conventional flow test and/or (ii) included amounts of reserves below lowest known oil or gas
 - any issues identified by the red-flag questions above;
- When creating the RRT, request that legal counsel assist in establishing both scope and operating procedures. To the extent possible, the RRT should take steps necessary to protect attorney-client privilege and any other applicable privilege with respect to its correspondence, notes and reports produced. In addition, the team should understand in advance the potential ramifications of its report and prepare for potential SEC enforcement or other legal actions against the company;
- The RRT should prepare a formal report of its findings, setting forth in detail any and all support and test results (including method of testing) for all amounts of proved reserves. The report should identify and itemize any and all potential deficiencies and/or weaknesses noted by the RRT in its review. The report should be provided directly to the company's audit committee, with a copy to the CEO and CFO, and to the head of E&P (or such other department responsible for management of reserves);
- To the extent the RRT discovers material issues with previous disclosure, the company should determine whether any previously reported proved reserves need to be restated. Note that, in addition to any current disclosure of any significant change in classifications, the company may also need to file an amendment to its annual report for the respective year to reflect any material reclassifications. In this regard, independent counsel should be consulted with respect to the preparation of the disclosure of any reclassification and any necessary amendments (see below) and to prepare for any possible enforcement or other legal proceedings.

SECOND: "Expertize" proved reserves figures through independent engineering firm investigation and verification. Companies should carefully consider retaining an independent engineering firm to provide some level of review of the company's proved reserves estimates (including, with respect to prior disclosure, the RRT's findings).¹¹ Companies of course may opt for varying levels of review, depending on the needs and internal expertise of each individual company, ranging from review of particular assets where issues are noted to the preparation of a complete independent audit and reserves report in support of any proved reserves booked.¹² While any level of review will carry with it certain costs, the perceived benefits of a third-party review in terms of independent corroboration of reserves estimates can augment regulator and investor confidence in these estimates. Companies that do not have independent engineers expertize their proved reserve numbers should take special care to ensure that they have a strong and functioning independent internal audit process (see below). Note that this should not detract from the need for companies to develop a strong, independent internal review process (discussed below).

¹¹ Several large petroleum companies, including Anadarko Petroleum and Shell, have recently hired independent consultants/engineers to review their proved reserves bookings. See Tyson, "Looking for Best Practices," Petroleum News (April 4, 2004) Vol. 9, No. 14.

¹² See Simmons & Company International Energy Industry Research Report, "Issue Spotlight — Oil & Gas Reserves," Feb. 25, 2004, at Appendix D, page 28.

THIRD: Establish or strengthen existing internal auditing of reserves and require involvement of personnel outside of the line of business who report directly to independent directors. Regardless of the company's decision with respect to engaging an independent engineering or consulting firm to review proved reserves estimates, all companies should ensure that they have a strong, independent internal reserves audit procedure with respect to all future reserves bookings. We recommend that this audit procedure comprise an audit at least annually of all properties. This internal reserves audit should be conducted from outside of the business line and report directly to the company's audit committee or other committee of independent directors.¹³ The reserves audit team should also regularly evaluate whether the policies set forth in the formal guidelines (described below) are being consistently implemented and adhered to. The internal reserves audit function should be incorporated into the company's operating procedures, and adequately staffed and funded.

FOURTH: Retain independent advisors to review reserves booking policies and procedures and to provide recommendations with respect to remedial actions and development of reserves booking guidelines compliant with SEC requirements. We urge companies to consult with, and obtain the review of, independent accounting experts and legal counsel with respect to the findings of the RRT and an examination of the extent to which a company's existing reserves management system and guidelines for the booking of proved reserves are consistent with the requirements of the SEC and applicable accounting guidelines. To ensure the independence of the review, we recommend that the review not be conducted by the company's legal counsel involved in preparing any of the disclosure of proved reserves, or by the accounting firm used to audit the company's financial statements. This recommendation is not intended to require the company to reaudit financial statements or other information, nor is it necessary to engage nationally recognized auditors, provided that the accounting expert selected has expertise in the interpretation and application of the relevant regulatory requirements.

FIFTH: Develop formal procedural guidelines for the preparation of future filings consistent with SEC requirements. The RRT should, in collaboration with management responsible for classifying reserves and in consultation with a company's independent advisors (see above), also prepare (or revise existing) formal procedural guidelines for reporting reserves to eliminate any inconsistency with the application of SEC rules and interpretations, and to clarify the standards that must be met to classify reserves as proved in accordance with SEC guidance. These guidelines should be formally adopted and incorporated into the company's operating procedures and internal process for the preparation of disclosure in any SEC filings, including annual reports and offering documents.

These guidelines will, of course, vary depending on the operations, organizational structures and size of a company, but in general should include, among other things:

- a requirement that proved reserves be reviewed on an annual basis (by the company's internal reserves audit team and/or external independent engineering firm, as discussed above in our second and third recommendations);
- regular training and education of employees involved in the company's reserves management system, starting with field engineers, so that their understanding of the applicable rules and regulations stays current;

¹³ The company's audit committee charter should reflect this reporting responsibility.

- a procedure whereby the guidelines are updated as necessary to comply with and incorporate any SEC interpretations. Responsibility for monitoring SEC guidance and any changes to requirements should be assigned;
- clear criteria for recognizing new proved reserves. Companies may wish to incorporate a checklist of required steps that must be taken to demonstrate recoverability with “reasonable certainty,” including:
 - verification of financial commitment for development (contract stage)
 - confirmation that the reserves can be produced within the current license period
 - adequate flow testing or other method compliant with SEC regulations
 - actual drilling;
- one of the following requirements for all future proposed booking of proved reserves: (a) An internal audit process. We would recommend that the internal reviewers report to a reserve audit committee outside of the business line. This committee does not need to be a committee of the board of directors. (b) Alternatively, this function can be carried out by an external engineering firm. In either case, this audit function should be properly staffed, with an adequate allocation of funds, and cover all or substantially all of the company’s asset portfolio. With respect to upcoming reports to be filed for the 2003 fiscal year, for companies without a developed internal reserve audit function already in place, we would recommend at a minimum an external review be conducted;
- a requirement for sub-certification of the head of the division or department responsible for classifying proved reserves, attesting to: (a) compliance with (i) the formal procedural guidelines, including any prescribed mandatory testing and/or criteria, and (ii) any SEC or other relevant U.S. or foreign regulatory requirements and/or definitions, and (b) the accuracy of the information provided for purposes of preparing the company’s accounts;¹⁴
- a mechanism whereby the person(s) responsible in the company for establishing and maintaining disclosure controls and procedures and internal controls over financial reporting pursuant to the Sarbanes-Oxley Act are able to review, in consultation with independent counsel, whether any recommendations of the RRT with respect to the classification of proved reserves (i) alters any previous conclusion regarding the effectiveness of either of these controls, (ii) identifies any potential significant deficiency or material weakness in the company’s internal controls, (iii) necessitates a change that could materially affect the company’s internal controls over financial reporting or (iv) otherwise creates the need for any additional disclosure and/or action with respect to disclosure controls and procedures and/or internal controls over financial reporting;¹⁵
- a policy of disclosing the age of proved undeveloped reserves (PUDs). This gives a company the ability to monitor the rate at which PUDs are converted into proved developed reserves, and to manage plans for economically developing these reserves (and confirming plan of development still current) and ensuring compliance with SEC guidelines;¹⁶

¹⁴ Sub-certifications are recommended for purposes of ensuring the ability of the CEO and CFO to provide the certifications required to be furnished to the SEC in conjunction with a company’s annual report filed on Form 20-F, pursuant to the Sarbanes-Oxley Act.

¹⁵ Note that this recommended requirement is intended to track in general the disclosure currently required under Items 307 and 308 of Regulation S-K (Item 15 of Form 20-F for foreign filers) and the officer certifications required as a result of SEC rulemaking mandated under the Sarbanes-Oxley Act. Certain additional disclosure required with respect to internal control over financial reporting will be effective for reports for fiscal years ending on or after April 15, 2005 (June 15, 2004, for accelerated filers).

¹⁶ For example, as part of an effort to dispel its reputation as an aggressive booker of reserves, Anadarko Petroleum recently implemented a policy of reviewing its PUDs annually, with particular focus on PUDs booked for three or more years. According to Anadarko, its onshore U.S. PUDs are generally converted to proved developed reserves within two years, while certain projects, including deepwater development and international projects, may take five years or more. See Anadarko Petroleum Annual Report for 2003, filed on Form 10-K with the SEC on March 4, 2004.

- a policy of recognizing proved reserves only when economic productibility is supported by actual production, or pursuant only to SEC-recognized methods of testing;
- a policy of only booking PUDs within one legal spacing of a commercially produced well and above lowest known oil;¹⁷
- a mechanism whereby any significant production decline in any field or other potential for changes in reserves in which the company has booked proved reserves triggers an automatic review and possible debooking of proved reserves in that field, and a policy of debooking proved reserves as soon as any trigger factors are met;
- a mechanism for monitoring the reporting of proved reserves by the company's partners and identifying when partners adjust disclosure of proved reserves;¹⁸
- a clear method for distinguishing and/or reconciling, as necessary, reserves reported for internal or international purposes and those reported in filings with the SEC;
- separate classification of oil-sands reserves;
- clear delineation between treatment and estimation of proved reserves under licenses (whether or not there are partners in the field) and production-sharing contracts or arrangements. For example, the guidelines should include a policy of only recognizing proved reserves in a production-sharing contract if the company has a clear risk of capital, and should provide clear principles for accounting for the special tax treatment of reserves in these arrangements;¹⁹
- a document retention policy;²⁰
- oversight of proved reserves estimates by the company's audit committee (or other committee of independent directors of the board);²¹
- separation of personnel involved in the reserves management system from any incentive bonus or other compensation plan related to reserves; and
- guidelines for standard cautionary disclosure in any offering document filed with the SEC with respect to the accuracy of any reserves estimates, any material assumptions and, to the extent the company reports its financial information according to non-U.S. GAAP, any differences in treatment of reserves in the company's financial statements in relation to U.S. GAAP.

¹⁷ See "SEC Engineers Opine on Reserves Reporting Cases," Reservoir Solutions, Ryder Scott Company Newsletter, Vol. 4, No. 4 (December-February 2002). See also Simmons & Company International Energy Industry Research Report, cited above in note 11.

¹⁸ This mechanism is important in order to ensure that the company's disclosure is in conformity with other companies engaged in activities in the same field, and to assess whether the company's booking of proved reserves may be overly aggressive.

¹⁹ In practice, there is a sliding scale based on the degree of ownership and exposure to risk and reward of each party. See "SEC Engineers Opine" cited above in note 15.

²⁰ Sections 802 and 1102 of the Sarbanes-Oxley Act provide for civil and criminal penalties for the destruction of corporate records with the intent to impede an official investigation.

²¹ The company's audit committee charter should reflect this oversight responsibility.

CONCLUSION

In the current environment, oil and gas companies are faced with an urgent need to ensure the accuracy of proved reserves estimates and to restore investor confidence in this key indicator of energy companies' performance. With the chances of an in-depth SEC review greater than ever, the increasing number of reserves-related class-actions lawsuits being filed, and investors becoming increasingly concerned and vocal about reserves matters, the ramifications of a "wait-and-see" approach could be costly. Companies should therefore be proactive and adopt a practical approach to addressing the concerns of the SEC and investors. To do this effectively, companies should conduct a review of recent disclosure of proved reserves, provide for independent verification of their reserves estimates, and ensure that they have formal reserves management procedures in place that are compliant with SEC requirements.

The foregoing recommendations are a general guide only. Companies should review the information above in the context of their existing operations, organizational structure and management objectives.

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