

ENERGY & GLOBAL TRANSACTIONS ALERT

SEC ADOPTS FINAL RULES MODERNIZING OIL AND GAS REPORTING DISCLOSURES

BACKGROUND

On December 31, 2008, the Securities and Exchange Commission (SEC) issued final rules for the “Modernization of Oil and Gas Reporting,” adopting revisions to its oil and gas reporting disclosures in Items 102, 801 and 802 of Regulation S-K and Rule 4-10 of Regulation S-X under the Securities Act of 1933 and the Securities Exchange Act of 1934, as well as Industry Guide 2. The SEC is also adding new Subpart 1200 to Regulation S-K. The SEC described the revisions as intending to provide investors with a more meaningful and comprehensive understanding of oil and gas reserves, which should help investors evaluate the relative value of oil and gas companies. The revisions are designed to modernize and update the oil and gas disclosure requirements, in order to align them with current practices and changes in technology over the last three decades since the initial adoption of these disclosure items. The final rules established a mandatory compliance date for registration statements filed on or after January 1, 2010, and for annual reports on Form 10-K and 20-F for fiscal years ending on or after December 31, 2009, with no voluntary early compliance permitted. However, as the SEC discusses its revisions with the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (as mentioned below), it will consider whether to delay the mandatory compliance date further.

On June 26, 2008, the SEC issued a proposing release seeking public comment on proposed amendments to the disclosure requirements regarding oil and gas companies. These proposals encompassed issues that were previously addressed more generally in a concept release that the SEC issued on December 12, 2007, which solicited comment on possible revisions to the oil and gas reserves disclosure requirements specified in

SEC CONCEPT RELEASE ISSUE	PROPOSED RULES	FINAL RULES
13. What aspects of technology should be considered in evaluating a disclosure framework?	<ul style="list-style-type: none"> Must be consistent with definition of “reliable technology” – expressed in realistic terms, has been proved empirically to lead to correct conclusions in over 90 percent of its applications. 	<ul style="list-style-type: none"> Adopted substantially as proposed, except that “reliable technology” need not be “widely accepted within the oil and gas industry” and did not adopt a bright line 90 percent test as proposed. See Item 1202(a)(6) of Regulation S-K. See also Rule 4-10(a)(25) of Regulation S-X.
14. Consider requiring companies to engage an independent third party to evaluate their reserves estimates in the filings?	<ul style="list-style-type: none"> Will not propose to require an independent third party. Will require disclosure regarding the qualifications of the person responsible for preparing reserves estimates. 	<ul style="list-style-type: none"> Adopted substantially as proposed. See Item 1202(a)(8) of Regulation S-K.

APPENDIX 1:

<http://akingumpinfo.com/ve/9200ht6182VJV61838/stype=click/OID=209112185734319/VT=0>

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Rule 4-10 of Regulation S-X and Item 102 of Regulation S-K. The proposing release also contained proposals not addressed by the concept release related to the updating and codification of Industry Guide 2. On July 8, 2008, we issued a client alert entitled “Proposed Revisions to the Securities and Exchange Commission’s Oil and Gas Reserves Disclosure Requirements,” which can be found at: <http://akingumpinfo.com/ve/9200ht6182VJV61838/stype=click/OID=909112185734358/VT=0>.

For the full text of the final rules release, see: <http://akingumpinfo.com/ve/9200ht6182VJV61838/stype=click/OID=50911218573461/VT=0>.

SUMMARY OF FINAL RULES

The following summarizes the revisions and the new disclosure requirements, many of which were requested by industry participants:

1. Revisions and additions to the definition section in Rule 4-10(a) of Regulation S-X, including–
 - the use of a 12-month average first-day-of-the-month price based on the company’s fiscal year to determine the economic producibility of reserves for both disclosure and full-cost accounting purposes
 - the expansion of the definition of “oil and gas producing activities” to include the extraction of hydrocarbons from oil sands, shale, coal beds or other non-renewable natural resources, and activities undertaken with a view to such extraction
 - the revision of the definition of “proved oil and gas reserves” and the addition of the definition of “reasonable certainty” to provide better guidance regarding the meaning of that term
 - the addition of the definition of “reliable technology” to permit the use of new technologies to establish proved reserves and revised disclosure requirements with respect to the relevant technologies used by the company
 - the addition of the definition of “reserves”, “probable reserves” and “possible reserves”
 - the addition of definitions to explain new terms used in the revised definitions.

Many of the definitions are designed to be consistent with the Petroleum Resource Management System (PRMS). The full text of the new and revised definitions under Rule 4-10 of Regulations S-X is attached to this client alert as Appendix 1.

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11. Consider eliminating any of the current exclusions from proved reserves?	<ul style="list-style-type: none"> • The proposed definition would allow unconventional resources such as oil shales and bitumen to be classified as proved reserves, would include provisions for establishing levels of lowest-known hydrocarbons and highest-known oil through reliable technology other than well penetrations and would also permit a company to claim proved reserves beyond drilling units that immediately offset developed drilling locations if reasonably certain to be economically producible. 	<ul style="list-style-type: none"> • Adopted substantially as proposed. See Rule 4-10(a)(22) of Regulation S-X.
12. Consider eliminating any of the current exclusions from oil and gas activities and/or consider eliminating the current restrictions on including oil and gas reserves from sources that require further processing?	<ul style="list-style-type: none"> • The proposed definition would state that oil and gas producing activities include the extraction of marketable hydrocarbons, in the solid, liquid or gaseous state, from oil sands, shale, coal beds or other nonrenewable natural resources, which can be upgraded into natural or synthetic oil or gas. • Would continue to exclude activities relating to transporting, refining and processing; the production of natural resources other than oil, gas or natural resources from which natural or synthetic oil and gas can be extracted; and the production of geothermal steam. 	<ul style="list-style-type: none"> • Adopted substantially as proposed. See Rule 4-10(a)(16) of Regulation S-X.

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	<ul style="list-style-type: none"> Reasonable certainty under a probabilistic method means that there is at least a 90 percent probability that the quantities actually recovered will equal or exceed the stated volume. 	<p>to be consistent with PRMS. If probabilistic methods are used, there should be at least a 90 percent probability that the quantities actually recovered will equal or exceed the estimate, consistent with PRMS. See Rule 4-10(a)(24) of Regulation S-X.</p>
7. Reconsider the concept of certainty with regard to proved undeveloped reserves?	<ul style="list-style-type: none"> Proposed to replace “certainty” test with “reasonable certainty” test for areas beyond one offsetting drilling unit from a productive well. 	<ul style="list-style-type: none"> Adopted substantially as proposed. See Rule 4-10(a)(31) of Regulation S-X. See also bullet 3 to point 4 above.
8. Reconsider the concept of economic producibility?	<ul style="list-style-type: none"> Proposed term to mean, “a resource which generates revenue that exceeds, or is reasonably expected to exceed, the costs of the operation.” 	<ul style="list-style-type: none"> Adopted substantially as proposed. See Rule 4-10(a)(10) of Regulation S-X.
9. Reconsider the concept of existing operation conditions?	<ul style="list-style-type: none"> No change proposed. 	<ul style="list-style-type: none"> Modified the concept of “existing economic conditions” to include prices and costs “at which economic producibility from a reservoir is to be determined.” See Rule 4-10(a)(24)(v) of Regulation S-X.
10. Should we require or allow companies to use an average price instead of a fixed price, or a futures price instead of a spot price?	<ul style="list-style-type: none"> Proposed to change the price used in calculating reserves from a single-day closing price measured on the last day of the company’s fiscal year to an average price for the 12 months prior to the end of the company’s fiscal year. Will add a disclosure item to permit a company, at its option, to include a sensitivity case analysis. 	<ul style="list-style-type: none"> Adopted substantially as proposed, with exclusion for prices that are defined by contractual arrangements. See Rule 4-10(a)(24)(v) of Regulation S-X. See also Item 1202 of Regulation S-K. Adopted substantially as proposed. See Item 1202(b) of Regulation S-K.

- Codification of the contents of Industry Guide 2 disclosures in a new Subpart 1200 of Regulation S-K. Industry Guide 2 will cease to exist upon the effectiveness of the final rules. New Subpart 1200 contains new disclosure requirements, including–

 - disclosure of reserves from non-traditional sources (i.e., bitumen, shale, coal beds) as oil and gas reserves
 - optional disclosure of probable and possible reserves
 - optional disclosure of oil and gas reserves’ sensitivity to price
 - disclosure of the company’s progress in converting proved undeveloped reserves into proved developed reserves, including those that are held for five years or more, and an explanation of why they should continue to be considered proved
 - disclosure of technologies used to establish reserves in a company’s initial filing with the SEC and in filings that include material additions to reserves estimates
 - the company’s internal controls over reserves estimates and the qualifications of the technical person primarily responsible for overseeing the preparation or audit of the reserves estimates
 - if a company represents that disclosure is based on the authority of a third party that prepared the reserves estimates or conducted a reserves audit or process review, the filing of a report prepared by the third party
 - disclosure based on a new definition of the term “by geographic area.”
- Form 20-F will refer to Subpart 1200, rather than Appendix A to Item 4.D, and therefore expands and harmonizes the disclosures required by foreign private issuers.
- SEC will coordinate its efforts with the IASB and FASB to ensure a smooth transition to the new reporting rules. It recommends that the change from using single-day year-end price to using an average price should be treated as a change in accounting principle that is inseparable from a change in accounting estimate; this does not require retroactive revision of reserves estimates. Based on such efforts, the SEC may consider whether to delay the mandatory compliance date for the final rules.

FINAL CHANGES AT A GLANCE

The chart below updates the chart included in our client alert on July 8, 2008, summarizing 14 key areas related to reserve reporting requirements explored in the concept release, what action the SEC proposed in its proposing release and what action the SEC took in its final rules:

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1. Replace our rules-based current oil and gas reserves disclosure requirements with a principles-based rule?	<ul style="list-style-type: none"> No specific changes proposed. 	<ul style="list-style-type: none"> Adopted a principles-based definition of “reliable technology.” See Rule 4-10(a)(25) of Regulation S-X. Adopted principles-based disclosure requirement regarding a company’s reserves estimates and internal controls in its reserves estimation effort. See Items 1202(a)(6) and (7) of Regulation S-K.
2. Consider allowing companies to disclose reserves other than proved reserves in filings with the SEC?	<ul style="list-style-type: none"> Proposal to make these disclosures voluntary Will require disclosure about the person primarily responsible for preparing the company’s reserves estimates. 	<ul style="list-style-type: none"> Adopted as proposed. See Item 1202 of Regulation S-K. See also Rules 4-10(a)(17) and (18) of Regulation S-X.
3. Adopt all or part of the Society of Petroleum Engineers - Petroleum Resources Management System (PRMS)?	<ul style="list-style-type: none"> Proposed new and revised definitions classification system based on both PRMS and the Canadian National Instrument 51-101. 	<ul style="list-style-type: none"> Adopted most of the new and revised definitions based on, or consistent with, PRMS and the Canadian Oil and Gas Evaluation Handbook (COGEH).
4. Consider revising the current definition of proved reserves, proved developed reserves and proved undeveloped reserves (PUDs)?	<ul style="list-style-type: none"> Will add a definition of the term “reserves” to describe more completely the criteria that an accumulation of oil, gas or related substances must satisfy to be considered reserves. 	<ul style="list-style-type: none"> Definition of “reserves” not adopted as proposed; adopted a definition that more closely parallels the PRMS definition of that term (except it is based on “economic producibility” rather than “commerciality”). See Rule 4-10(a)(26) of Regulation S-X.

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	<ul style="list-style-type: none"> Will expand the definition of the term “proved developed reserves” to include extraction of resources using technologies other than production through wells. Undrilled locations can be classified as PUDs generally if a development plan is adopted to drill within five years. 	<ul style="list-style-type: none"> Other than eliminating the term “proved”, adopted substantially as proposed. Added concept that reserves are also developed if the cost of any required equipment is relatively minor compared to the cost of a new well (consistent with PRMS). See Rule 4-10(a)(6) of Regulation S-X. Adopted “reasonable certainty” test as proposed; replaced the term “unusual circumstances” with “specific circumstances” so as not to exclude projects that typically take more than five years to develop. Company would be required to disclose why such undeveloped reserves have not been developed. Otherwise adopted substantially as proposed. See Rule 4-10(a)(31) of Regulation S-X. See also Item 1203 of Regulation S-K.
5. Specify the tests a company must undertake to estimate reserves?	<ul style="list-style-type: none"> Companies would now be able to select the technology used and be required to disclose that technology for investors to determine whether that technology was appropriate. 	<ul style="list-style-type: none"> Adopted new definition of “reliable technology” that requires a technology be field tested and demonstrated to provide reasonably certain results with consistency. See Rule 4-10(a)(25) of Regulation S-X. See also Item 1202(a)(6) of Regulation S-K.
6. Reconsider the concept of reasonable certainty?	<ul style="list-style-type: none"> Proposed to define the term as “much more likely to be achieved than not” under a deterministic or probabilistic method. 	<ul style="list-style-type: none"> Adopted substantially as proposed; however, modified terminology (e.g. “high degree of confidence” rather than “much more likely than not” if deterministic methods are used)