DAVIS POLK & WARDWELL

Date: January 23, 2009

To: Interested Persons

Re: **SEC Finalizes Revisions to Oil and Gas Disclosure Requirements: New Rules Provide for Wider Range of Reserves Disclosures with Potential Impact on Upstream Valuations**

After a year of proposed rulemaking, the US Securities and Exchange Commission (SEC) recently finalized the first amendments to its reserves and other reporting requirements for the oil and gas industry since those rules were first adopted thirty years ago. In its release, "Modernization of Oil and Gas Reporting" (Release Nos. 33-8995, 34-592192), the SEC expanded the scope of hydrocarbon resources that qualify as "reserves", made significant revisions to the criteria used to estimate "proved reserves" (many of which give issuers greater latitude to classify reserves as "proved"), reversed the prohibition on disclosing "probable" and "possible" reserves in SEC filings and made other changes to the existing disclosure regime for the upstream industry. The new rules will apply to annual reports for years ending on or after December 31, 2009 and to registration statements filed beginning January 1, 2010. In order to promote comparability among issuers, early adoption of the rules is not permitted.

Key changes to the existing disclosure regime include:

- ***Non-traditional resources.*** The definition of "reserves" has been expanded to include saleable hydrocarbons extracted from non-traditional resources such as oil sands, shale and coal intended for upgrading into synthetic oil and gas.

- ***New definition of "reasonable certainty".*** For the first time, the concept of "reasonable certainty" that is the basis for classifying reserves as "proved" has been defined and clarified. Importantly, the new rules permit the use of "reliable technology" to establish "reasonable certainty" in the absence of actual well penetration. Proved reserves estimates will therefore reflect the use of existing, established technologies that until now have not been consistent with interpretations of "reasonable certainty" as well as new technologies field tested . . . and demonstrated to provide reasonably certain results with consistency and repeatability."

- ***Bright-line limitations relaxed.*** Bright-line, technical limitations on classifying reserves as "proved" under the current rules such as the one-well offset requirement for defining undrilled acreage and the "lowest

known hydrocarbon" (LKH) limit have been effectively replaced by the general concept of "reasonable certainty".

- ***12-month average pricing.*** The price used to determine whether reserves are "economically producible" has been changed from the current year-end spot price to a 12-month unweighted average (unless the relevant price is otherwise defined by contract). Citing the need for comparability, the SEC has clarified that "economic producibility" of reserves will still be determined on the basis of the undiscounted stream of estimated revenues and costs of development and production. In addition, the SEC made the analogous change to pricing for purposes of its full-cost accounting rules and stated that it was in discussions with the Financial Accounting Standards Board (FASB) to align its standards with 12-month average pricing for those companies using the successful efforts method.

- ***New disclosures for PUDs and geographic concentrations.*** The new rules introduce mandatory narrative disclosures regarding "proved undeveloped reserves" (PUDs), a topic of investor focus in recent years. In addition to disclosing year-end volumes and material changes over the course of the year, issuers will have to disclose (1) investments and progress made to convert PUDs to proved developed reserves and (2) why material concentrations of PUDs in individual fields or countries have remained undeveloped for five years or more after initially being classified as proved.

  The new rules also require tabular breakdowns of proved reserves, both developed and undeveloped, by product and by geographic area (defined as an individual country, countries within a continent or a continent) containing 15% of an issuer's proved reserves.

- ***Optional disclosure of "unproved" reserves and sensitivity analysis.*** The new rules eliminate the current ban on including disclosure of reserves other than proved in reports and registration statements filed with the SEC. Many companies already disclose information about "probable" and "possible" reserves on websites and elsewhere outside their SEC filings. In an attempt to give investors better insight into the reserves base used by management to make investment decisions, the new rules permit companies to disclose both "probable" and "possible" reserves data in their filings. Citing concerns that the greater uncertainty associated with probable and possible reserves estimates could increase liability risk, the SEC made the new disclosures voluntary. Estimates of oil and gas resources that do not qualify as "reserves" in SEC filings remain prohibited.

Companies may also opt to disclose a sensitivity analysis of aggregate reserves by product based on different price and cost criteria, including standardized futures prices or management forecasts. Price and cost schedules and other assumptions underlying the scenarios presented must be disclosed.

- ***Filing of reserves audit and other third-party reports.*** Issuers will now have to file copies of relevant third-party reports as exhibits if they represent in their SEC filings represent that a consulting engineer or other third party prepared a reserves estimate, conducted a reserves audit or performed a "process review" of its reserves estimation process. The filed report may be a shorter version of the full reserves or other report actually delivered by the third party so long as it contains specified disclosure regarding the purpose, effective date, scope and conclusions of the report.

While it will take time for their impact to be reflected in company reports, the new rules can be expected to shape disclosure across the upstream industry. Potential effects on disclosure include:

- Increases in proved and other reserves, subject to fluctuations in price, at least in the first year of application, as a result of the relaxation of existing technical constraints on the use of technology to establish "proved" status under current rules and the inclusion of non-traditional resources as reserves.

- Less volatility in year-to-year changes in proved estimates through the use of 12-month average rather than year-end pricing.

- New disclosures on the conversion of "proved undeveloped reserves" (PUDs) to developed status that may shed light on investment criteria and technical performance.

- Broader disclosure regarding companies' total reserves base and sensitivities to price and other factors that may offer greater insight into management decision making and prospects.

- Greater variation in reserves estimates and related disclosures among issuers depending on the relative diversity and maturity of their upstream portfolios and other factors.

These developments could lead to changes in sector and company valuations, valuation methodologies and M&A and capital-raising dynamics, especially over

a period of depressed or fluctuating oil prices. They may also have an impact on covenant compliance and borrowing capacity under existing finance documents.

If you have any questions about the matters covered in this memorandum, please contact any of the lawyers listed below or your regular Davis Polk contact:

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