



CLIENT MEMORANDUM

SEC Modernizes Reporting Requirements of Oil and Gas Companies

January 26, 2009

In its release of December 31, 2008 (the "Adopting Release"),¹ the U.S. Securities and Exchange Commission (the "SEC") adopted amendments to its oil and gas reserve disclosure requirements to allow investors to better evaluate companies' reserves and their attendant values. The revisions modernize and update the disclosure requirements to align them with current industry practices and changes in technology. The amendments revise Regulation S-K, Regulation S-X and Industry Guide 2, as well as concurrently aligning the full cost accounting rules with the revised disclosure requirements. Additionally, the changes seek to harmonize oil and gas disclosures by foreign private issuers with the disclosures made by domestic companies. The amendments take effect on January 1, 2010.

BACKGROUND OF THE ADOPTING RELEASE

The SEC's original oil and gas reserve disclosure requirements were adopted in 1978 and 1982. Since their adoption,

significant changes in the oil and gas industry, including technological advances, caused many industry participants to express concern that the original disclosure requirements had not kept up with current practices, and were therefore of limited value.² On December 12, 2007, the SEC issued a concept release soliciting public comment on possible revisions to the disclosure requirements,³ the results of which were subsequently used to prepare the disclosure requirement amendments proposed by the SEC on June 26, 2008.⁴

¹ "Modernization of Oil and Gas Reporting," Release No. 33-8995 (34-59192) (December 31, 2008).

² See *SEC Today, SEC Adopts New Oil and Gas Reporting Requirements*, vol. 2009-2 (Jan. 5, 2009).

³ "Concept Release on Possible Revisions to the Disclosure Requirements Relating to Oil and Gas Reserves," Release No. 33-8870 (34-56945) (December 12, 2007).

⁴ See "Modernization of the Oil and Gas Reporting Requirements," Release No. 33-8935 (34-58030) (June 26, 2008).

AMENDMENTS OF EXISTING RULES

The revisions and additions to the definition section of Rule 4-10(a) of Regulation S-X were designed in part to be consistent with the Petroleum Resource Management System, a widely accepted standard for the management of petroleum resources developed by several industry organizations.⁵ Among other things, the revisions address four key issues raised by companies, investors, and security analysts.

- **The pricing mechanism to determine the economic producibility of reserves**

In calculating the economic producibility of oil and gas reserves, the revised rules require the use of an average price based on the prior 12-month period, unless prices are defined by contractual arrangements. The rules had previously required the use of a single-day, year-end price. In announcing the changes, the SEC stated that "the use of the average price will maximize the comparability of reserves estimates among companies and mitigate the distortion of the estimates that arises when using a single pricing date."⁶

- **The exclusion of activities related to "non-traditional" resources from the definition of "oil and gas producing activities"**

In recognizing that advances in technology had increasingly allowed activities related to the extraction of bitumen and other "non-traditional" resources to provide energy resources to the world,⁷ the SEC amended the definition of "oil and gas producing activities" to include such resources. The SEC did state, however, that the distinction between traditional and unconventional activities is still important from an investor's perspective because unconventional activities tend to be costlier and therefore require higher pricing before production is economically justifiable. New Item

1202 of Regulation S-K will require registrants to separate in tabular form reserves based on final products that are traditional oil or gas from those that are synthetic oil or gas.⁸

In addition, the definition of "oil and gas producing activities" was amended to include activities relating to the processing or upgrading of natural resources from which synthetic oil or gas can be extracted, but would continue to exclude the transporting, refining, processing or marketing of oil and gas, the production of natural resources other than oil, gas or natural resources from which synthetic oil and gas can be extracted, and the production of geothermal steam.⁹

- **The limitations on the types of technologies that may be relied upon to establish reserve estimates and categories**

The previous definition of "reliable technology" had limited the use of alternate technologies as the basis for determining a company's reserve disclosures and categories. In recognizing that technology would continue to develop and desiring to improve the quality of information that could be obtained from existing tests and tests yet to be created, the SEC revised the definition to permit the use of new technologies or a combination of technologies to establish reserve estimates and categories if such technologies have been demonstrated empirically to lead to reliable conclusions.¹⁰

⁵ See Adopting Release, Section II.A.

⁶ SEC Press Release No. 2008-304 (December 29, 2008).

⁷ See Adopting Release, Section II.C.1.

⁸ See Adopting Release, Section II.C.2.

⁹ See Adopting Release, Section II.C.2.

¹⁰ See Adopting Release, Section II.G.1

- **The limitation that permits only the disclosure of proved reserves**

The Adopting Release introduced new definitions of “probable reserves” and “possible reserves”, as well as new Item 1202 of Regulation S-K, to allow companies to disclose, in addition to their proved reserves, their probable and possible reserves.¹¹

Furthermore, the revised rules require companies to, among other things, disclose the internal controls used in a reserves estimation and the qualifications of a reserves preparer or auditor¹² and, if a company represents that a third party prepared a reserves estimate or conducted a reserves audit, file a report of such third party as an exhibit.¹³

The SEC had proposed to add a new Item to Regulation S-K which would have specified topics that a company should address in its Management's Discussion and Analysis of Financial Condition and Results of Operations (“MD&A”) or in a separate section. However, the SEC recognized that if companies were to discuss every proposed topic, the disclosure would be too long and detailed to be of much use to most investors, and instead provided, for guidance purposes, a list of suggested topics that a company might need to discuss in its MD&A.¹⁴

CONCLUSION

The revisions to the oil and gas company reporting requirements regarding energy reserves were brought on by significant changes in the oil and gas industry and markets, including technological advances and new projects in which oil and gas companies invest. Overall, the new rules and amendments seek to improve and modernize the disclosure by oil and gas companies without sacrificing clarity and comparability.

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¹¹ See Adopting Release, Section II.H.

¹² See Adopting Release, Section IV.B.3.d.

¹³ See Adopting Release, Section IV.B.3.e.

¹⁴ See Adopting Release, Section V.
