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Client Alert

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SEC ANNOUNCES MAJOR CHANGES TO DISCLOSURE REQUIREMENTS FOR OIL AND GAS COMPANIES

On December 31, 2008, the Securities and Exchange Commission (“SEC”) approved significant revisions to modernize and update the reporting requirements for oil and gas companies.¹ Under the new rules:

- Many companies are likely to report larger reserves due to inclusion of oil and gas from non-traditional sources, such as bitumen, and “probable” and “possible” reserves;
- Investors will receive a more meaningful and comprehensive understanding of oil and gas reserves;
- Disclosures will be modernized to better align them with technological changes and current practices in the oil and gas industry; and

- SEC classifications and terminology will be aligned with those of the Petroleum Resources Management System (PRMS) developed by the Society of Petroleum Engineers.

Many of the above changes are being accomplished by revising and codifying Industry Guide 2, the prior guide to oil and gas company disclosure for domestic issuers, into Regulation S-K.

Companies will need to comply with the new disclosure requirements for registration statements filed on or after January 1, 2010, and for annual reports on Forms 10-K and 20-F for fiscal years ending on or after December 31, 2009. However, the SEC stated that it might consider delaying the compliance date further based on the results of its coordination of some of the discussed changes with the Financial Accounting Standards Board (“FASB”) and the International Accounting Standards Board (“IASB”). Early compliance with the new rules is not permitted.

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¹ Securities and Exchange Commission, Release Nos. 33-8995 and 34-59192, *Modernization of Oil and Gas Reporting*, December 31, 2008, available at <http://sec.gov/rules/final/2008/33-8995.pdf>. The revisions affect disclosure requirements in Regulation S-K and Regulation S-X under the Securities Act of 1933 and the Securities Exchange Act of 1934, as well as Industry Guide 2.

Switch to 12-Month Average Pricing

Oil and gas reserves estimates are typically assessed based on the economic producibility of a reservoir. The economic aspects of reserves have previously been assessed using a single-day, year-end price. The new rules require the use of a 12-month average price, calculated as the unweighted arithmetic average of the first-day-of-the-month price for each month within the 12-month period prior to the end of the reporting period (however, if prices are set by contractual arrangements, the contract price will be used instead of the 12-month average without regard to escalations based upon future conditions). The switch to an average price is meant to maintain comparability between companies' reserves disclosures while mitigating the effects of short-term volatility and seasonality associated with the use of a one-day price.

The SEC has stated that it will interface with the FASB in order to conform current accounting standards with the new 12-month average price standard to ensure that companies do not have to perform a different set of reserves calculations for accounting purposes than the one used for disclosure purposes.² Such resulting changes to the accounting are to take effect prospectively (starting with registration statements filed on or after January 1, 2010, and annual reports on Forms 10-K and 20-F for fiscal years ending on or after December 31, 2009), with no retroactive adjustments required for prior periods reported.

² Currently, for accounting purposes when using the full cost method, companies use the single-day, year-end price to estimate reserves for purposes of determining depreciation, depletion and amortization of certain capitalized costs included on the balance sheet. However, while the new method minimizes the impact of pricing anomalies, companies should still discuss any material pricing trends that could result if there is a possibility of future write-downs under the full cost method.

Reserves to Include Oil and Gas from Non-Traditional Sources

The current definition of "oil and gas producing activities" explicitly excludes sources of oil and gas extracted by means other than "traditional" oil and gas wells. The new definition focuses on the final product of such activities, and specifically states that "oil and gas producing activities include the extraction of saleable hydrocarbons, in the solid, liquid, or gaseous state, from oil sands, shale, coalbeds, or other nonrenewable natural resources which are intended to be upgraded into synthetic oil or gas, and activities undertaken with a view to such extraction." This allows activities such as bitumen extraction from oil sands, as well as oil and gas extraction from coal and shales, to fall under the definition. Therefore, companies will have to provide disclosure of their mining activities for such resources included under the "oil and gas producing activities" umbrella.

In maintaining the final product criterion as the major one in the above evaluation, the rules prohibit a company from including in its oil and gas reserves products that could be converted into oil and gas (like coal and oil shale) if it is not the company's intent to convert the products into oil and gas. Moreover, the disclosures need to distinguish between traditional oil and gas and synthetic oil and gas.

New Technologies Permitted to Establish Reserves

The new rules allow more flexibility in determining proved oil and gas reserves than through the current well-penetration method. The concept of "reliable technology" is introduced to account for new technological innovations (including computational methods). A technology can be used as long as it has been demonstrated empirically

to lead to reliable conclusions about reserves volumes, therefore allowing companies to claim proved reserves based on methods other than well penetration. Additionally, alternative technologies are also allowed to be used to claim proved reserves even beyond development spacing areas that are immediately adjacent to developed spacing areas, through the use of a reasonable certainty standard as explained below.

Disclosure of the use of new technologies is required in a company's initial filing with the SEC and in filings that include material additions to reserves estimates. However, the disclosure is to be of a general nature and limited to a concise summary, without revealing proprietary technologies at a level that would cause competitive harm. The SEC will, as before, reserve the right to request more detailed information from a company as part of its review and comment process.

Proved, Probable and Possible Reserves, and the Development Concept

The new rules clarify the reasonable certainty standard for proved reserves, and align it with the PRMS definition which requires that there be at least a 90% probability, if probabilistic methods are used, that the quantities actually recovered will equal or exceed the estimate.

The new rules will also allow, but not require, companies to disclose "probable" and "possible" reserves to investors, whether the reserves were obtained using deterministic estimates (estimates based on a single value for each geoscience, engineering, or economic parameter), or probabilistic estimates (estimates based on the full range of possible values for each unknown geoscience and engineering parameter, generating a full range of possible outcomes). Currently,

the SEC's rules limit disclosure to proved reserves. The objective behind the change is to enable companies to provide investors with more information about the potential reserves on which a company's management might base its resource allocations.

"Probable" reserves are those additional reserves that are less certain to be recovered than proved reserves but which, together with proved reserves, are as likely as not to be recovered. When deterministic methods are used to determine reserves, the actual remaining quantities recovered would as likely as not exceed the sum of estimated proved plus probable reserves. When probabilistic methods are used, the standard to be utilized for probable reserves is at least a 50% probability that the actual quantities recovered will equal or exceed the proved plus probable reserves estimates.

"Possible" reserves are those additional reserves that are less certain to be recovered than probable reserves. When deterministic methods are used to determine reserves, the total quantities ultimately recovered from a project would have a low probability to exceed the sum of proved, probable, and possible reserves. Alternatively, when probabilistic methods are used, the standard is at least a 10% probability that the actual quantities recovered will equal or exceed the sum of proved, probable, and possible reserves estimates.

The concept of "development" with respect to reserves references the costs associated with equipment required to extract such reserves. The new rules state that reserves are developed if the cost of any required equipment is relatively minor compared to the cost of a new well or the cost of the equipment currently installed. With respect to undeveloped reserves, the previous calculation methodology had allowed companies to only include quantities that can be recovered, or whose existence has been established, using techniques proved

effective by actual production from projects in the same area and in the same reservoir. The revised calculation methodology now allows the counting of quantities that can be recovered through techniques proven effective by actual production not only in the same area and reservoir, but also if proven effective in an analogous reservoir, whose conditions are no more favorable than the reservoir in question, or by other technology that establishes reasonable certainty.

New Disclosures Requirements

The new rules will require a company to disclose production in each country or field containing 15% or more of a company's proved reserves, and disclose reserves estimates in each country containing more than 15% of a company's proved reserves, provided that either type of disclosure is not prohibited by the country to which the disclosure relates. There is no requirement to provide disclosure of reserves by sedimentary basin or field.

In addition, the new rules will permit companies to include price sensitivity analyses, provided they disclose the prices, cost schedules, and assumptions on which such reserves estimates are based.

The new rules also require a company to provide a general discussion of the internal controls that it uses to assure objectivity in the reserves estimation process. Companies will also have to disclose the qualifications of the technical person primarily responsible for preparing the reserves estimates. While a company is not required to enlist the help of a third party in preparing the reserves estimate or conducting a reserves audit of the reserves estimates, the company must file a summary version of any third party report as an exhibit to the relevant registration statement or report, along with that party's consent (the SEC specifies certain disclosures that must be contained within such summary). The

requirement to file third party reports also applies to process audits, along with disclosure of the details surrounding such process review.

Companies also have to disclose, in a narrative form, the aging of proved undeveloped reserves, and explain the specific circumstances regarding any such reserves that have remained undeveloped for a period of five years or more.

Furthermore, the new rules allow disclosure of reserves of end products other than oil and gas. Products which the company does not intend to convert to oil and gas, such as bitumen being sold by the company before final conversion, will have to be reported separately.

The SEC also included in the rule pronouncement various suggested items which it advises companies to discuss in their MD&A if such items would present material information to investors. Such topics include, among others, changes in reserves due to changes in pricing, concession rights, or other technical matters, and technologies being used pursuant to the new rules.

While foreign private issuers have been subject to less onerous disclosure requirements by having their disclosures governed by Appendix A to Item 4.D of Form 20-F, the new rules harmonize domestic and foreign company disclosure by eliminating Appendix A and requiring all issuers, both domestic and foreign, to follow the same disclosure requirements outlined in Regulation S-K. While many foreign private issuers had voluntarily provided domestic-like disclosure in the past, many will have to tackle disclosure relating to drilling activities, present activities, delivery commitments, wells, and acreage for the first time once the new rules become effective (with previous allowances excepting disclosure where prohibited by foreign law still being applicable).

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Global Securities Group, whose names and contact information are provided below.

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