

## ENERGY UPDATE

### SEC Issues New Oil and Gas Disclosure Rules, Gives Transition Guidance

*March 2, 2009*

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The US Securities and Exchange Commission (SEC) published final rules and interpretations regarding its oil and gas reporting requirements. The SEC's new disclosure rules are contained in [SEC Release No. 33-8995](#), and are the first significant revisions to Rule 4-10 of Regulation S-X and Item 102 of Regulation S-K (and the related Industry Guides) under the Securities Act of 1933 and the Securities Exchange Act of 1934 since the adoption of the original reporting requirements almost 30 years ago. The revisions modernize the SEC's oil and gas disclosure rules to better coincide with current industry practices so that they are more useful to the market and investors.

Additionally, the SEC intended to more closely align the definitions contained in Regulation S-X with the standards endorsed by the Petroleum Resources Management System (PRMS).<sup>1</sup> The new rules also codify Industry Guide 2 into a new Subpart 1200 of Regulation S-K,<sup>2</sup> and revise Form 20-F to require foreign private issuers to comply with Subpart 1200 and make the same oil and gas disclosures as those required of domestic issuers instead of their complying with the guidance set forth in Appendix A

to the Form 20-F, which has been deleted. The final rules follow the proposed rules release in [SEC Release No. 33-8935](#) on June 26, 2008, and the concept release in [SEC Release No. 33-8870](#) on December 12, 2007.

**Effective Date.** The final rules require companies to begin complying with the disclosure requirements for registration statements filed on or after January 1, 2010, and for annual reports on Forms 10-K and 20-F (for foreign private issuers) for fiscal years ending on or after December 31, 2009. In order to allow sufficient time for transition, and to improve comparability of the disclosures, a company may choose not to apply the new rules before its annual report for its first fiscal year that ends after December 15, 2009. Thus, for US calendar year-reporting registrants the disclosures will be first required for their annual report on Form 10-K for the year ending December 31, 2009. However, the release also noted that the SEC would consider whether to delay the compliance date as it works during 2009 with the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) to

harmonize its revisions with the standards promulgated by these organizations.

**Significant Changes.** The most significant changes to the reporting requirements include:

- The “economic producibility” of reserves shall be calculated using a 12-month average price, rather than a year-end spot price;
- The definition of “oil and gas producing activities” will now include “non-traditional” and “unconventional” sources, such as bitumen extracted from oil sands as well as oil and gas extracted from coal and shales;
- The previously undefined term “reasonable certainty” is now defined to mean “high degree of confidence” to better align with the PRMS definition;
- The “certainty” test for proved undeveloped reserves beyond one offsetting drilling unit is replaced with a “reasonable certainty” test;
- The types of technologies that a company may use to establish reserves estimates and categories is broadened by the adoption of the new definition of “reasonable technology”;
- Optional disclosure of “probable” and “possible” reserves is now permitted; and
- Additional disclosures will be required regarding the company’s chief technical person overseeing the company’s overall reserves estimation process and the filing of third-party reports (such as independent petroleum engineers’ reports) when a third party has estimated or audited the company’s reserves.

These changes are discussed in greater detail below.

## Revisions and Additions to the Definitions in Rule 4-10 of Regulation S-X

The new definitions contained in the final release reflect changes in the oil and gas industry that have occurred in the decades since the current rules were adopted.

By changing these definitions, the SEC intended to be more consistent with the PRMS definitions without sacrificing an investor’s ability to make comparisons between companies.

### PRICING MECHANISM FOR OIL AND GAS RESERVES ESTIMATION

Under the new rules, “proved oil and gas reserves” are defined in part as those quantities of oil and gas that, by analysis of geoscience and engineering data, can be estimated with reasonable certainty to be economically producible. To determine the economic producibility of reserves, the prior rules measured reserves using a single-day year-end price. The new rules specify that in calculating economic producibility, a company must use 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. This means that a company with a reporting year end of December 31 would determine its reserves estimates for its annual report based on the average of the prices for oil or gas on the first day of every month from January through December. If any prices are defined by contractual arrangements, those prices (excluding escalations based upon future conditions) may be used.

New Item 1202 of Regulation S-K requires disclosure, both in the aggregate and by geographic area, of reserves estimates using prices and costs under existing economic conditions, for each product type, for the following categories: proved developed reserves; proved undeveloped reserves; total proved reserves; probable developed reserves (optional); probable undeveloped reserves (optional); possible developed reserves (optional); and possible undeveloped reserves (optional). The tabular format of this table is set forth below.

The proposed rules had suggested that companies use a 12-month average price to estimate reserves for disclosure purposes, but use a single-day, year-end price for accounting purposes. Due to strong opposition to this proposal by the commenters, the SEC decided not to adopt this rule. Instead, both the disclosure rules and the full-cost accounting rules related to oil and gas reserves will use a single price based on the 12-month average. The SEC will continue to communicate with the FASB staff to align their accounting standards with these rules.

### Summary of Oil and Gas Reserves as of Fiscal Year-End Based on Average Fiscal-Year Prices

	RESERVES				
	Oil	Natural Gas	Synthetic Oil	Synthetic Gas	Product A
Reserves category	(mbbls)	(mmcf)	(mbbls)	(mmcf)	(measure)
<b>PROVED</b>					
<b>Developed</b>					
Continent A					
Continent B					
Country A					
Country B					
Other Countries in Continent B					
<b>Undeveloped</b>					
Continent A					
Continent B					
Country A					
Country B					
Other Countries in Continent B					
<b>TOTAL PROVED</b>					
<b>PROBABLE</b>					
Developed					
Undeveloped					
<b>POSSIBLE</b>					
Developed					
Undeveloped					

The adopting release noted that many of the commenters advocated that oil and gas futures prices, or management’s forecast of future prices, would better represent the value of the reserves and be better aligned with the fair value of the reserves. The SEC chose not to adopt this approach, citing that differences in assumptions by different companies could reduce the comparability

of reserves information among companies. However, the rules as adopted will permit supplemental disclosures by companies using an optional reserves sensitivity table that will set forth information regarding the sensitivities that oil and gas reserves have to price fluctuations under various scenarios. Item 1202(b) of Regulation S-K contains the tabular format for such a table:

### Sensitivity of Reserves to Prices By Principal Product Type and Price Scenario

Price Case	Proved Reserves			Probable Reserves			Possible Reserves		
	Oil mmbbls	Gas mmcf	Product A measure	Oil mmbbls	Gas mmcf	Product A measure	Oil mmbbls	Gas mmcf	Product A measure
Scenario 1									
Scenario 2									

#### PROVED OIL AND GAS RESERVES AND REASONABLE CERTAINTY

The final rules define the term “proved oil and gas reserves” in part as:

those quantities of oil and gas, which, by analysis of geoscience and engineering data, can be estimated with reasonable certainty to be economically producible—from a given date forward, from known reservoirs, and under existing economic conditions, operating methods, and government regulations—prior to the time at which contracts providing the right to operate expire, unless evidence indicates that renewal is reasonably certain, regardless of whether deterministic or probabilistic methods are used for the estimation.

Additionally, a definition of the term “reasonable certainty” adopts the “high degree of confidence” standard under PRMS.

“High degree of confidence” means that a quantity is “much more likely to be achieved than not, and, as changes due to increased availability of geoscience (geological, geophysical and geochemical), engineering and economic data are made to estimated ultimate recovery (EUR) with time, reasonably certain EUR is much more likely to increase or remain constant than to decrease.” The SEC also adopted, as proposed, revisions that permit a company to claim proved reserves beyond those development spacing areas that are immediately adjacent to developed spacing areas if the company can establish with reasonable certainty that these reserves are economically producible.

The definition of “reasonable certainty” addresses, and permits the use of, both deterministic methods and probabilistic methods for estimating reserves. A “deterministic estimate” is defined as an estimate based on a single value for each parameter (from geoscience, engineering or

economic data) in the reserves calculation that is used to estimate reserves. A “probabilistic estimate” is defined as an estimate that is obtained when the full range of values that could reasonably occur from each unknown parameter (from the geoscience and engineering data) is used to generate a full range of possible outcomes from their associated probabilities of occurrence. If deterministic methods are used, “reasonable certainty” means a high degree of confidence that the quantities will be recovered. If probabilistic methods are used, “reasonable certainty” means there should be at least a 90% probability that the quantities actually recovered will equal or exceed the estimate.

#### EXTRACTION OF BITUMEN AND OTHER NON-TRADITIONAL RESOURCES

The prior definition of “oil and gas producing activities” explicitly excluded sources of oil and gas from “non-traditional” or “unconventional” sources. This excluded sources that involve extraction by means other than “traditional” oil and gas wells, including bitumen extracted from oil sands and oil and gas extracted from coal and shale. The revised definition of “oil and gas producing activities” includes the extraction from non-traditional sources. This is intended to shift the focus of the definition of “oil and gas producing activities” to the final product of such activities, regardless of the extraction technology used. The new definition 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 that are intended to be upgraded into synthetic oil or gas. The new

rules also provide that companies will be required to include coal and oil shale that are intended to be converted into oil and gas as oil and gas reserves. The definition of “oil and gas producing activities” will continue to exclude: (i) transporting, refining, processing or marketing oil and gas; (ii) the production of “natural resources” other than oil, gas or natural resources from which synthetic oil and gas can be extracted; and (iii) the production of geothermal steam.

#### DEVELOPED AND UNDEVELOPED OIL AND GAS RESERVES

The new definition of “proved developed oil and gas reserves” is reserves that “(i) in projects that extract oil and gas through wells, can be expected to be recovered through existing wells with existing equipment and operating methods; and (ii) in projects that extract oil and gas in other ways, can be expected to be recovered through extraction technology installed and operational at the time of the reserves estimate.” Consistent with PRMS, reserves are also developed if the cost of any required equipment is relatively minor compared to the cost of a new well.

Currently, the definition of the term “proved undeveloped reserves” (PUDs) imposes a “reasonable certainty” standard for reserves in drilling units immediately adjacent to the drilling unit containing a producing well and a “certainty” standard for reserves in drilling units beyond the immediately adjacent drilling units. For areas beyond one offsetting drilling unit from a productive well, the new rules would replace the existing “certainty” test with a “reasonable certainty” test. The new rules also expand the definition

of the term “undeveloped oil and gas reserves” to permit the use of techniques that have been proven effective by actual production from projects in the same reservoir or an analogous reservoir, or “by other evidence using reliable technology that establishes reasonable certainty.”

#### RELIABLE TECHNOLOGY

The new rules also expand the definition of “reliable technology” to broaden the types of technologies that a company may use to establish reserves estimates and categories. The new definition of “reliable technology” permits the use of technology (including computational methods) that has been field tested and has demonstrated consistency and repeatability in the formation being evaluated or in an analogous formation. This new standard will permit the use of a new technology or a combination of technologies once a company can establish and document the reliability of that technology or combination of technologies. As a result of comments received, the SEC decided not to require that the reliable technology be “widely accepted” (because that could exclude proven internally developed technologies) or have been proven empirically to lead to the correct conclusion in 90% or more of its applications (due to the difficulty in verifying such a bright line number on an ongoing basis).

The company is also required to provide a concise summary of the technology or technologies used to create the estimate. A company would not be required to disclose proprietary technologies, or a proprietary mix of technologies, at a level of specificity that would cause competitive harm. As part of its review and comment process, the SEC

may continue to request that companies provide supplemental data, including information sufficient to support a company’s conclusion that a technology meets the definition of “reliable technology.” In that event, companies should consider requesting confidential treatment for the supplemental data requested under the SEC’s Freedom of Information Act procedures under 17 CFR § 200.83.

#### UNPROVED RESERVES — “PROBABLE RESERVES” AND “POSSIBLE RESERVES”

Currently, oil and gas companies are permitted to disclose only “proved reserves” in their SEC filings. The new rules will permit disclosure of “probable reserves” and “possible reserves.” If a company chooses to disclose probable or possible reserves, it must provide the same level of geographic detail as is required for proved reserves, and it must state whether the reserves are developed or undeveloped.

Consistent with the PRMS definition, “probable reserves” are those additional reserves that are less certain to be recovered than proved reserves but which, in sum with proved reserves, are as likely as not to be recovered. This definition provides guidance for the use of both deterministic and probabilistic methods. The definition clarifies that, when deterministic methods are used, it is as likely as not that actual remaining quantities recovered will equal or exceed the sum of estimated proved plus probable reserves. Similarly, when probabilistic methods are used, there must be at least a 50% probability that the actual quantities recovered will equal or exceed the proved plus probable reserves estimates.

The new definition of “possible reserves” provides that possible reserves include those additional reserves that are less certain to be recovered than probable reserves. It clarifies that, when deterministic methods are used, the total quantities ultimately recovered from a project have a low probability of exceeding the sum of proved, probable and possible reserves. When probabilistic methods are used, there must be at least a 10% probability that the actual quantities recovered will equal or exceed the sum of proved, probable and possible estimates.

#### DEFINITION OF RESERVES

The new rules define “reserves” as the estimated remaining quantities of oil and gas and related substances anticipated to be economically producible, as of a given date, by application of development projects to known accumulations. “Economically producible,” in turn, means that the value of the product produced which generates revenue, as determined at the terminal point, exceeds, or is reasonably expected to exceed, the costs of the operation. In addition, there must exist, or there must be a reasonable expectation that there will exist, the legal right to produce a revenue interest in the production of oil and gas, installed means of delivering oil and gas or related substances to market, and all permits and financing required to implement the project. This definition is consistent with PRMS, with one notable difference: the PRMS definition is based on “commerciality,” while the SEC definition is based on “economic producibility.” The SEC felt that commerciality introduced a subjective aspect to the price used to establish existing economic conditions by

factoring an internal rate of return required by a company (which varies by company) into the formula. This would reduce comparability among company disclosures. Therefore, the new definition of “reserves” relies on economic producibility.

#### New Subpart 1200 to Regulation S-K Codifying Industry Guide 2

The new rules also add a new Subpart 1200 to Regulation S-K that codifies the disclosure requirements for companies engaged in oil and gas producing activities. Subpart 1200 contains the disclosures required in Industry Guide 2, which have been revised and updated. Subpart 1200 contains the following disclosure requirements:

#### ITEM 1201: GEOGRAPHIC AREA

In the proposed release, the SEC noted that oil and gas companies have had differing interpretations as to the level of specificity required when a company is breaking out its reserves disclosures based on geographic area as required by Instruction 3 of Item 102 of Regulation S-K. Statement of Financial Accounting Standards No. 69 (SFAS 69) requires reserves disclosure for the company’s home country and foreign geographic areas to be separately disclosed. Under the new rules, the term “by geographic area” shall mean, as appropriate for meaningful disclosure under a company’s particular circumstances: (i) by individual country; (ii) by groups of countries within a continent; or (iii) by continent. This definition is substantially the same as the definition currently provided in SFAS 69. With respect to production, the final rules require

disclosure of production in each country or field containing 15% or more of the company's proved reserves unless disclosure is prohibited by the laws or regulations of the country in which the reserves are located. A proposal to require disclosure of reserves by sedimentary basin or field was not adopted because several commenters were concerned that this amount of detail would make disclosures too complex and incoherent, and that the disclosures by basin and by field could cause competitive harm in future property sales, unitization agreements and other transfers.

#### ITEM 1202: DISCLOSURE OF RESERVES

The current instructions to Item 102 of Regulation S-K require disclosure of proved reserves. New Item 1202 expands this disclosure to permit disclosure of probable and possible reserves. It requires disclosure, in the aggregate, by geographic area and by final product (oil, gas, synthetic oil, synthetic gas or other natural resource), of proved developed, proved undeveloped and total reserves. It also permits disclosure of probable developed, probable undeveloped, possible developed and possible undeveloped reserves. If a company chooses to disclose probable and possible reserves, it must provide the geographic detail required of proved reserves, must state whether the reserves are developed or undeveloped and disclose the relative uncertainty associated with the classification of the reserves.

As mentioned above, the new rules require a company to determine whether its oil or gas resources are economically producible based

on a 12-month average price and allow a company to include an optional reserves sensitivity table to show the sensitivity of hydrocarbon reserves to price fluctuations.

Item 1202 requires a company to provide a general discussion of the internal controls that it uses to assure objectivity in the reserves estimation process. It also requires disclosure of the qualifications of the technical person primarily responsible for preparing the reserves estimates or conducting the reserves audit if the company discloses that a reserves audit has been performed, regardless of whether the technical person is an employee or an outside third party. However, the SEC did not require that a company retain an independent third party to prepare reserves estimates or conduct a reserves audit of the company's reserves estimates. If a third party prepared the reserves estimate or conducted an audit of the reserves estimates, the company must file a report of the third party as an exhibit to the relevant registration statement or other SEC filing. These reports should be the short form reports that summarize the scope of work and the conclusions of the third party.

#### ITEM 1203: PROVED UNDEVELOPED RESERVES

Item 1203 requires a disclosure, in narrative form, of (i) the total quantity of PUDs at year end, (ii) any material changes in PUDs that occurred during the year, including PUDs converted into proved developed reserves, (iii) investments and progress made during the year to convert PUDs to

proved developed oil and gas reserves, and (iv) an explanation of the reasons why material concentrations of PUDs in individual fields or countries have remained undeveloped for five years or more after their disclosure as PUDs. The final rules did not adopt the table that was in proposed Item 1203 because of commenters' concern that the table would be too complex for investors to understand.

#### ITEM 1204: OIL AND GAS PRODUCTION

Item 1204 codifies Industry Guide 2 disclosure regarding oil and gas production with several revisions. In addition to Industry Guide 2's required disclosure, by final product sold, of oil, gas and other products produced, for each of the prior three fiscal years, Item 1204 requires disclosure, by geographical area (as described above), of the average sales price per unit of oil, gas or other products produced and the average production costs (not including ad valorem and severance taxes) per unit of production.

#### ITEM 1205: DRILLING AND OTHER EXPLORATORY AND DEVELOPMENT ACTIVITIES

Item 1205 codifies the existing disclosures found in Industry Guide 2 related to drilling activities and adds one new provision. The new provision requires that a company discuss its exploratory and development activities regarding oil and gas resources that are extracted by mining techniques because such resources are now included in the definition of "oil and gas producing activities."

#### ITEM 1206: PRESENT ACTIVITIES

Item 1206 codifies existing Item 7 of Industry Guide 2, which calls for disclosure of present activities, including the number of wells in the process of being drilled (including wells temporarily suspended), the waterfloods in the process of being installed, pressure maintenance operations and any other related activities of material importance.

#### ITEM 1207: DELIVERY COMMITMENTS

Item 1207 codifies existing Item 8 of Industry Guide 2, which calls for disclosure of arrangements under which the company is required to deliver specified amounts of oil or gas and how the company intends to meet such commitments.

#### ITEM 1208: OIL AND GAS PROPERTIES, WELLS, OPERATIONS AND ACREAGE

Item 1208 codifies existing Industry Guide 2 disclosure regarding oil and gas properties, wells, operations and acreage. The SEC decided not to adopt the proposed revisions to the disclosure that would have required disclosure by product, by type of accumulation and by geographic location.

#### GUIDANCE FOR MD&A

The SEC chose not to adopt proposed Item 1209, which would have specified topics a company should address in its MD&A or in a separate section, because of concern that if companies discussed every issue in the proposed item, the disclosure would be too long and detailed to be of much use to investors. Instead the SEC

chose to provide guidance regarding topics a company might need to discuss in its MD&A. The topics are:

- Changes in proved reserves and, if disclosed, in probable and possible reserves and the sources to which such changes are attributable, including those made due to changes in prices and technical revisions and changes in the status of concessions held (terminations, renewals or changes in provisions);
- Technologies used to establish the appropriate level of certainty for any material additions to, or increases in, reserves estimates;
- Prices and costs, including the impact on depreciation, depletion and amortization as well as the full cost ceiling test;
- Performance of currently producing wells, including water production from such wells and the need to use enhanced recovery techniques to maintain production from such wells;
- Performance of any mining-type activities for the production of hydrocarbons;
- The company's recent ability to convert proved undeveloped reserves to proved developed reserves, and, if disclosed, probable reserves to proved reserves and possible reserves to probable or proved reserves;
- The minimum remaining terms of leases and concessions;
- Material changes to any line item in the tables described in Items 1202 through 1208 of Regulation S-K;

- Potential effects of different forms of rights to resources (such as production sharing contracts) on operations; and
- Geopolitical risks that apply to material concentrations of reserves.

### Alignment of Foreign Private Issuer Disclosure to Domestic Issuers

Currently, foreign private issuers do not refer to Industry Guide 2 for disclosure. Instead they obtain guidance on disclosure from Appendix A to Item 4.D in Form 20-F, which is significantly shorter and provides less guidance than Industry Guide 2. The new rules require that foreign private issuers, like domestic issuers, must refer to Subpart 1200 for their disclosures. However, this new rule would not apply to those foreign private issuers who are under the Multi-Jurisdictional Disclosure System (MJDS) using Form 40-F that conforms with NI 51-101 in Canada because those rules are already consistent with PRMS.

### Guidance for Transition to New Requirements

The adopting release indicated that the SEC has begun working with the FASB and the IASB to harmonize its new rules with the models being developed by those organizations in order to ensure a smooth transition to the new reporting regime.

While the 12-month average price will be used for accounting purposes under the full cost accounting method described in Rule 4-10(c) of Regulation S-X, questions arise for reporting companies using the successful efforts method of accounting

under Statement of Accounting Standards No. 19 — “Financial Accounting and Reporting by Oil and Gas Producing Companies” (SFAS 19). The SEC’s adopting release also revises Section 406.01B of the SEC’s Codification of Financial Reporting publication, noting that the new amendments to the definitions in Rule 4-10(a) may not align completely with the existing terminology and application of SFAS 19. The adopting release notes that paragraph 7 of Statement of Financial Accounting Standards No. 25 — “Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies—an amendment of FASB Statement No. 19” (SFAS 25) has stated that, “For purposes of applying this Statement and Statement 19, the definition of proved reserves, proved developed reserves, and proved undeveloped reserves shall be the definitions adopted by the SEC for its reporting purposes that are in effect on the date(s) as of which the reserve disclosures are to be made. Previous reported quantities shall not be revised retroactively if the SEC definitions are changed.” In any event, the adopting release indicates that the SEC expects the practical application of SFAS 19 will remain unchanged other than incorporating the effects of the new definitions.

The SEC also expressed its view that the accounting change resulting from the changes in definitions and required pricing assumptions in Rule 4-10 or Regulation S-X (including from using single-day year-end price to an average price) should be treated as a change in accounting principle that is inseparable from a change in accounting

estimate. As a change in accounting estimate pursuant to Statement of Financial Accounting Standard No. 154 — “Accounting Changes and Error Corrections” (SFAS 154), the change would be accounted for prospectively, and not retroactively. Thus, no retroactive revision to prior results is required. Furthermore, the adoption of the rules will not require retroactive revision of past reserves estimates.

Additionally, as previously noted, under the new rules the extraction of certain products such as bitumen will be considered oil and gas producing activities, not mining activities. Under current US accounting guidance, costs associated with proven plus probable mining reserves may be capitalized for operations extracting products through mining methods, like bitumen. The new rules will require bitumen extraction and operations that produce oil or gas through mining methods to be included under oil and gas accounting rules, which only permit capitalization of costs associated with proved reserves. With respect to these resources formerly considered mining activities, the adopting release indicated that the SEC views this change from mining treatment to oil and gas treatment as a change in accounting principle that is inseparable from a change in accounting estimate, which will also not require retroactive revisions.

Finally, the SEC did not adopt interactive data requirements under its eXtensible Business Reporting Language initiative in the adopting release, indicating that while much of the disclosures regarding

oil and gas companies under Subpart 1200 of Regulation S-K would be conducive to interactive data, their adoption would not be addressed until the SEC had created a well-developed nomenclature and categorization for these disclosures.

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## Endnotes

- <sup>1</sup> The PRMS is a widely accepted standard for the management of petroleum resources developed by several industry organizations, including the Society of Petroleum Engineers, the World Petroleum Council and the American Association of Petroleum Geologists.
- <sup>2</sup> Subpart 229.1200 of Regulation S-K — “Disclosure by Registrants Engaged in Oil and Gas Producing Activities.”

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*If you have any questions about the new disclosure rules, please contact your usual Mayer Brown lawyer, or one of the following lawyers.*

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