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Santos

29 June 2010

The Chairman
Australian Accounting Standards Board
P O Box 204
Collins Street
West Victoria, 8007

Request for Comment on IASB Discussion Paper DP/2010/1 *Extractive Activities*

Santos is pleased to provide comments on the International Accounting Standards Board ("IASB") Discussion Paper DP/2010/1 *Extractive Activities* ("the DP").

While our responses to the specific questions outlined in the DP are enclosed in Attachment A, here follows a summary of our overall conclusions and opinions:

- We agree with the project teams approach to standardising the accounting for extractive industries, including the use of the SPE definitions of reserves and resources for the oil and gas industry;
- We support the recognition of assets when the legal right to undertake extractive activities is obtained and measurement using an historical cost method rather than a fair value approach. However, our preferred approach would be to capitalise costs under a more principles based successful efforts method, rather than a full cost approach;
- We agree with the disclosure proposals for quantities of oil and gas reserves based on SPE/PRMS requirements, however we believe that reserves disclosures should be presented outside of the financial statements and not be subject to financial statement audit.
- We are opposed to the inclusion of value based disclosures of the assets in the financial statements, including detailed disclosure of market and economic assumptions and that there should be no requirement to disclose sensitivity analysis on oil and gas reserves. In our view market participants do not place reliance on this type of information; and
- While Santos understands the objectives of the Publish What You Pay Coalition, we do not support the inclusion in the proposed Extractive Industries standard of a requirement to disclose information relating to payments to governments on a country by country basis.

The oil and gas industry in particular faces some unique accounting challenges stemming from its risk sharing practices which currently results in divergent accounting practices which the DP does not address. It is likely that divergent practices will continue in some key areas of accounting for extractive industries activities if considered guidance is not included in the final accounting standard. We have provided a list including a brief summary of some these unique transactions in Attachment B, for your consideration.

If you have any questions concerning our comments, please do not hesitate to contact me on +61 8 8116 5231.

Yours sincerely,

Peter Wasow
Chief Financial Officer & Executive Vice President

Copy to:
International Accounting Standards Board

Responses to Invitation to Comment on ED/2009/2 *Income Tax* ("the ED")

Question 1 – Scope of extractive

We have no comment in relation to extending the scope beyond the upstream activities for minerals, oil and natural gas.

Question 2 – Approach

We agree with having a single accounting and disclosure model that applies to the extractive activities for both the minerals industry and the oil and gas industry.

Question 3 – Definitions of minerals and oil and gas reserves and resources

We agree with the proposed use of the SPE/PRMS definitions of reserves and resources for oil and gas industry.

Question 4 – Minerals or oil and gas asset recognition model—Recognition

We support the recognition of assets when the legal right to undertake extractive activities is obtained. However our preferred approach would be to expense costs where the expenditure does not positively contribute information about the existence of a prospective resource or existing reserve. We believe this more principles based approach would overcome most of the criticism levelled at the more commonly currently applied rules based versions of the successful efforts method.

Under the *Framework* an asset is recognised when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably. The *Framework* expands on this to state that an asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the entity beyond the current accounting period. Instead, such a transaction results in the recognition of an expense in the income statement.

Based on the above definition of an asset we do not agree with capitalising costs to an asset where the costs incurred have resulted in negative information on the resource/reserve and therefore it will be improbable that economic benefits will flow to the entity. For example, expenditure incurred on a drilling a dry hole should not be capitalised as it is improbable that economic benefits will flow to the entity beyond the current accounting period as a result of that expenditure.

Similarly where costs have been incurred that result in positive information on a resource/reserve or the information is still under assessment, the costs should be capitalised to the asset as it is not improbable that the future economic benefits will flow to the entity. For example, costs incurred on a seismic programme that increases the definition of the reservoir or is still under assessment should be capitalised to the asset. Once an assessment is finalised the costs should either be expensed or remain in the asset.

Question 5 – Minerals or oil and gas asset recognition model—unit of account selection

We support the project team's view on the unit of account which for exploration rights would initially be defined according to the exploration rights held. As exploration and evaluation takes place, the size of the unit of account would contract so that by the time of development and production the geographical dimension of the unit of account would ultimately be no greater than a single area, or group of contiguous areas, for which the rights are held, which is managed separately, and which would generate largely independent cash flows.

It should be noted that units of account can increase. For example, Unitisations occur in the oil and gas industry where owners of petroleum reserves pool their individual interests in return for an interest in the overall unit which is then operated by a single entity on behalf of the venturers.

Question 6 – Minerals or oil and gas asset measurement model

We support the project team's view of measuring the upstream assets using an historical cost method rather than a fair value approach.

We acknowledge that historical cost information is not useful in terms of future value assessments. However, we do believe that analysts are interested in this information as an indicator of the finding and development cost performance of the Company. Accordingly, we believe that financial statements should disclose the total of costs expended on properties held and showing amounts subsequently expensed, written off, impairment adjustments and/or accumulated depletion separately in arriving at the carrying value of properties.

Question 7 – Testing exploration properties for impairment

We support the project team's view that while exploration and evaluation activities are continuing the properties should not be tested for impairment under *AASB 136 Impairment of assets* and that management should write down an exploration property only when, in its judgement, there is a high likelihood that the carrying amount will not be recoverable in full. A separate set of indicators appropriate to assess whether exploration properties can continue to be recognised as assets should be promulgated.

Question 8 – Disclosure objectives

We are broadly supportive of requiring additional disclosure related to reserves in the extractive industries.

We agree with the proposed disclosure of quantities of oil and gas reserves based on SPE/PRMS requirements including a general description of the bases upon which the reserves have been determined. We believe disclosure of the range of reserves and contingent resource estimates is useful information and should be required ie 1P, 2P and 3P reserves and 1C, 2C and 3C contingent resources.

We are opposed to disclosing sensitivity analysis for the reserves quantities. We do not believe that users of financial statements will place reliance on this disclosure. Sensitivity analysis across a useful range of assumptions with the appropriate rigor for inclusion in external reporting will require a significant amount of work for little value add. It is not appropriate simply to run sensitivities on product pricing assumptions without considering the impact on related economic variables and the cost of inputs where a correlation exists between commodity prices and the cost of some inputs. Further, different assumptions about future economic conditions may also fundamentally change project development concepts significantly impacting recoverable reserves.

We believe that the principle objective of analysts using reserves information is to obtain reliable information to allow them to model the future cash flows of the company. Providing disclosure on the reserves and resources quantities supporting the oil and gas assets determined in accordance with SPE requirements will provide the user with sufficient information which, when combined with other sources of information they have available to them, will allow them to generate their own modelling of future cash flows and cash flow sensitivities.

Disclosure of aggregate company reserves data does not provide sufficient information for analysts to model future cash flows of Company's that have multiple products and operate in many jurisdictions. Accordingly, we believe that reserves disclosures should be product based and disaggregated by geography or type of jurisdiction. Alignment with reporting of segment activities as a minimum should be required.

We are opposed to the inclusion of value based disclosures of the assets in the financial statements as we do not believe that users of financial statements will place any reliance on company generated valuations of reserves. Further, requiring detailed disclosure of market and economic assumptions applied in company generated valuations will in effect disclose the Directors' Valuation of the reserves which is commercially sensitive information and in some instances could be misinterpreted as the Directors' view of the value of the company as a whole.

If value based disclosures are to be made we believe a standardised approach to determining the underlying economic assumptions should be adopted to enhance comparability between companies and overcome, at least in part, the potential commercial problems of disclosing the Directors' view of future market and economic conditions and applicable discount rates.

We are also concerned that financial statement auditors are not in the practice of, nor do they have the skills for, auditing the technical, commercial and economic assumptions that under-pin reserves estimates. Further, traditional financial statement materiality concepts do not sit well with the fundamental nature of reserves and resources estimation and valuation and we would anticipate auditor qualifications on disclosures within financial statements which would undermine the credibility of reserves disclosures and the veracity of the financial statements as a whole.

Accordingly, we believe that reserves disclosures should be presented outside of the financial statements and not be subject to financial statement audit.

Question 9 – Types of disclosure that would meet the disclosure objectives

Refer previous question.

Question 10 – Publish What You Pay disclosure proposals

While Santos understands the objectives of the Publish What You Pay Coalition, we do not support the inclusion in the proposed Extractive Activities Standard a requirement to disclose information relating to payments to governments on a country by country basis. We do not believe that the inclusion of this information is warranted under the existing framework. However, should the IASB pursue this matter further, it should develop an appropriate framework and approach that would be applied to all industries rather than focusing on the extractive industries.

Other Specific Industry Matters

In addition to the fundamental approach to recognising oil and gas assets and reserves disclosures, the oil and gas industry in particular faces some unique accounting challenges stemming from its risk sharing practices. The discussion paper does not address a number of these unique transactions which occur particularly in the exploration and evaluation phase, and which we believe currently results in significant divergent accounting practices, which had effectively been grandfathered under the existing IFRS6. As such, we would request guidance be included in the standard to ensure consistent industry accounting practices on transactions specific to the extractive activities, including the following:

Less than all parties

A project in which only some of the venture parties participate, resulting in potential changes to the percentage ownership interest in joint venture asset or penalty charges to be paid by the non-participating party to subsequently buy back into the project at the venturer's original interest;

Unitisations

Where owners of petroleum reserves pool their individual interests in return for an interest in the overall unit which is then operated by a single entity on behalf of the group;

Re-determinations

An adjustment to the ownership interest in a reserves pool due to an agreed redetermination of the proportion of initial reserve assets contributed by each venture party;

Farm-ins and carried interests

Transfer of part of an oil or gas interest in consideration for:

- a specified consideration; and/or;
- an agreement by the transferee to meet certain expenditure that would otherwise have to be undertaken by licensee;

Depletion

Depletion calculations of oil and gas assets need to be clarified as there is currently divergent practice. Oil and gas assets can be depleted based on current production over the life of the reserves base of the asset on several bases (including 1P developed, 1P, 2P) producing materially different depletion expense outcomes. In our opinion, depletion should be based on 2P reserves as this best represents the expected reserves outcome for the asset. To produce any booked undeveloped reserves, a company will be required to undertake future capital works to access the undeveloped reserves. These future costs, in our opinion should be included in the amount that is depleted. If these costs are included in the depletable amount then should the included amount be the current cost of the required capital programme (our view), a discounted value or the expected future value?

Accounting for resource rent style taxes

The Australian Government has imposed a Petroleum Resource Rent Tax (PRRT) on the 'taxable profit' of a petroleum projects instead of traditional royalties. The AASB issued an interpretation in November 2007 - Interpretation 1003 *Australian Petroleum Resource Rent tax*, which requires the PRRT to be accounted within the scope of AASB 112 Income Taxes rather than a royalty expense. There could be divergent accounting practice, if other Governments have similar style taxes, as the IASB have not issued the same interpretation;

Accounting for production sharing agreements

Agreements are entered into between an Extractive Industries Company and a Government to explore for and, if successful, develop a reserve.

- Generally the Company bears the cost of the development;
- the Company receives all revenue until they have recovered their costs; and
- The subsequent revenue is shared with the Government.

Accounting for production sharing agreements by the Company can take a few different approaches, including:

- accounting 100% of the revenue and including an expense for the amount payable to the Government;
- accounting for a proportionate share of the revenue;
- accounting for the costs as a tax, where the taxation standard is applied which requires the balance sheet approach; and

Accounting for underlift /overlift sales

Lifting or offtake arrangements for oil and gas produced in jointly owned operations are frequently such that it is not practicable for each participant to receive or sell its precise share of the overall production during the period. Any resulting short term imbalance between cumulative production entitlement and cumulative sales attributable to each participant at a reporting date represents overlift or underlift.

It is likely that divergent practices will continue in some key areas of accounting for extractive industries activities if considered guidance is not included in the final accounting standard.