

Accounting policies

Year ended 31 December 2008

(a) General information

Tullow Oil Plc is a company incorporated in the United Kingdom under the Companies Act 1985. The address of the registered office is given on page 134. The nature of the Group's operations and its principal activities are set out in the operations and finance reviews on pages 20 to 43.

(b) Adoption of new and revised standards

Two Interpretations issued by the International Financial Reporting Interpretations Committee are effective for the current period. These are: IFRIC 11 – Group and Treasury Transactions and IAS 19 – The Limit on Defined Benefit Asset, Minimum Funding requirements and their interaction. The adoption of these Interpretations has not led to any changes in the Group's accounting policies.

At the date of authorisation of these financial statements, the following Standards and Interpretations which have not been applied in these financial statements were in issue but not yet effective (and in some cases have not yet been adopted by the EU).

IFRS 1/ IAS 27	Cost of and investment in a subsidiary, jointly controlled entity or associate
IFRS 2	Share-based payment – Vesting conditions and cancellations (amended)
IFRS 3	Business combinations (revised 2008)
IFRS 8	Operating segments
IAS 1	Presentation of financial statements (revised 2008)
IAS 23	Borrowing cost (revised 2007)
IAS 27	Consolidated and separate financial statements (revised 2008)
IAS 32/ IAS 1	Puttable financial instruments and obligations arising on liquidation (amended)
IFRIC 12	Service concession arrangements
IFRIC 15	Agreements for the construction of real estate
IFRIC 16	Hedges of a net investment in a foreign operation

Improvements to IFRS (May 2008)

The Directors anticipate that the adoption of these Standards and Interpretations in future periods will have no material impact on the financial statements of the Group except for:

- additional segment disclosures when IFRS 8 comes into effect for periods commencing on or after 1 January 2009; and
- treatment of acquisition of subsidiaries when IFRS 3 comes into effect for business combinations for which the acquisition date is on or after the beginning of the first annual period beginning on or after 1 July 2009.

(c) Basis of accounting

The financial statements have been prepared in accordance with International Financial Reporting Standards ('IFRS') adopted by the European Union and therefore the Group financial statements comply with Article 4 of the EU IAS Regulation.

The financial statements have been prepared on the historical cost basis, except for derivative financial instruments that have been measured at fair value. The principal accounting policies adopted by the Group are set out below.

(d) Basis of consolidation

The consolidated financial statements incorporate the financial statements of the Company and entities controlled by the Company (its subsidiaries) made up to 31 December each year. Control is achieved where the Company has the power to govern the financial and operating policies of an investee entity so as to obtain benefits from its activities.

Minority interests in the net assets of consolidated subsidiaries are identified separately from the Group's equity therein. Minority interests consist of the amount of those interests at the date of the original business combination (see below) and the minority's share of changes in equity since the date of the combination. Losses applicable to the minority in excess of the minority's interest in the subsidiary's equity are allocated against the interests of the Group except to the extent that the minority has a binding obligation and is able to make an additional investment to cover the losses.

The results of subsidiaries acquired or disposed of during the year are included in the Group Income Statement from the effective date of acquisition or up to the effective date of disposal, as appropriate.

Where necessary, adjustments are made to the financial statements of subsidiaries to bring the accounting policies used into line with those used by the Group.

All intra-group transactions, balances, income and expenses are eliminated on consolidation.

Business combinations

The acquisition of subsidiaries is accounted for using the purchase method. The cost of the acquisition is measured at the aggregate of the fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the Group in exchange for control of the acquiree, plus any costs directly attributable to the business combination. The acquiree's identifiable assets, liabilities and contingent liabilities that meet the conditions for recognition under IFRS 3 are recognised at their fair value at the acquisition date, except for non-current assets (or disposal groups) that are classified as held for sale in accordance with IFRS 5 non-current assets held for sale and discontinued operations, which are recognised and measured at fair value less costs to sell. Goodwill arising on acquisition is recognised as an asset and initially measured at cost, being the excess of the cost of the business combination over the Group's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities recognised. If, after reassessment, the Group's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities exceeds the cost of the business combination, the excess is recognised immediately in profit or loss.

(d) Basis of consolidation continued

Joint ventures

The Group is engaged in oil and gas exploration, development and production through unincorporated joint ventures. The Group accounts for its share of the results and net assets of these joint ventures as jointly controlled assets. In addition, where Tullow acts as operator to the joint venture, the gross liabilities and receivables (including amounts due to or from non-operating partners) of the joint venture are included in the Group Balance Sheet.

(e) Non-current assets held for sale

Non-current assets (or disposal groups) classified as held for sale are measured at the lower of carrying amount and fair value less costs to sell. Non-current assets and disposal groups are classified as held for sale if their carrying amount will be recovered through a sale transaction rather than through continuing use. This condition is regarded as met only when the sale is highly probable and the asset (or disposal group) is available for immediate sale in its present condition. Management must be committed to the sale which should be expected to qualify for recognition as a completed sale within one year from the date of classification.

(f) Revenue

Sales revenue represents the sales value, net of VAT and overriding royalties, of the Group's share of liftings in the year together with tariff income. Revenue is recognised when goods are delivered and title has passed.

Revenues received under take-or-pay sales contracts in respect of undelivered volumes are accounted for as deferred income.

Interest income is accrued on a time basis, by reference to the principal outstanding and at the effective interest rate applicable, which is the rate that exactly discounts estimated future cash receipts through the expected life of the financial asset to that asset's net carrying amount.

(g) Over/underlift

Lifting or offtake arrangements for oil and gas produced in certain of the Group's jointly owned operations are such that each participant may not receive and sell its precise share of the overall production in each period. The resulting imbalance between cumulative entitlement and cumulative production less stock is 'underlift' or 'overlift'. Underlift and overlift are valued at market value and included within debtors and creditors respectively. Movements during an accounting period are adjusted through Cost of Sales such that Gross Profit is recognised on an entitlements basis. The Group's share of any physical stock, warehouse stock and materials are accounted for at the lower of cost and net realisable value.

(h) Foreign currencies

The Pound Sterling is the presentation currency of the Group. For the purpose of presenting consolidated financial statements, the assets and liabilities of the Group's foreign operations are translated at exchange rates prevailing on the balance sheet date. Income and expense items are translated at the average exchange rates for the period, unless exchange rates fluctuate significantly during that period, in which case the exchange rates at the date of transactions are used. Currency translation adjustments arising on the restatement of opening net assets of foreign subsidiaries, together with differences between the subsidiaries' results translated at average rates versus closing rates, are taken directly to reserves. All resulting exchange differences are classified as equity until disposal of the subsidiary. On disposal, the cumulative amounts of the exchange differences are recognised as income or expense.

Transactions in foreign currencies are recorded at the rates of exchange ruling at the transaction dates. Monetary assets and liabilities are translated into Sterling at the exchange rate ruling at the Balance Sheet date, with a corresponding charge or credit to the Income Statement. However, exchange gains and losses arising on monetary items receivable from or payable to a foreign operation for which settlement is neither planned nor likely to occur, which form part of the net investment in a foreign operation, are recognised in the foreign currency translation reserve and recognised in profit or loss on disposal of the net investment. In addition, exchange gains and losses arising on long-term foreign currency borrowings which are a hedge against the Group's overseas investments, are dealt with in reserves.

(i) Exploration, evaluation and production assets

The Group adopts the successful efforts method of accounting for exploration and appraisal costs. All licence acquisition, exploration and evaluation costs are initially capitalised in cost centres by well, field or exploration area, as appropriate. Directly attributable administration costs and interest payable are capitalised insofar as they relate to specific development activities. Pre-licence costs are expensed in the period in which they are incurred.

These costs are then written off as exploration costs in the Income Statement unless commercial reserves have been established or the determination process has not been completed and there are no indications of impairment.

All field development costs are capitalised as property, plant and equipment. Property, plant and equipment related to production activities are amortised in accordance with the Group's depletion and amortisation accounting policy.

(j) Commercial reserves

Commercial reserves are proven and probable oil and gas reserves, which are defined as the estimated quantities of crude oil, natural gas and natural gas liquids which geological, geophysical and engineering data demonstrate with a specified degree of certainty to be recoverable in future years from known reservoirs and which are considered commercially producible. There should be a 50 per cent statistical probability that the actual quantity of recoverable reserves will be more than the amount estimated as a proven and probable reserves and a 50 per cent statistical probability that it will be less.

(k) Depletion and amortisation – discovery fields

All expenditure carried within each field is amortised from the commencement of production on a unit of production basis, which is the ratio of oil and gas production in the period to the estimated quantities of commercial reserves at the end of the period plus the production in the period, generally on a field-by-field basis. Costs used in the unit of production calculation comprise the net book value of capitalised costs plus the estimated future field development costs. Changes in the estimates of commercial reserves or future field development costs are dealt with prospectively.

Where there has been a change in economic conditions that indicates a possible impairment in a discovery field, the recoverability of the net book value relating to that field is assessed by comparison with the estimated discounted future cash flows based on management's expectations of future oil and gas prices and future costs. Where there is evidence of economic interdependency between fields, such as common infrastructure, the fields are grouped as a single cash generating unit for impairment purposes.

Any impairment identified is charged to the Income Statement as additional depletion and amortisation. Where conditions giving rise to impairment subsequently reverse, the effect of the impairment charge is also reversed as a credit to the Income Statement, net of any depreciation that would have been charged since the impairment.

(l) Decommissioning

Provision for decommissioning is recognised in full when the related facilities are installed. A corresponding amount equivalent to the provision is also recognised as part of the cost of the related property, plant and equipment. The amount recognised is the estimated cost of decommissioning, discounted to its net present value, and is reassessed each year in accordance with local conditions and requirements. Changes in the estimated timing of decommissioning or decommissioning cost estimates are dealt with prospectively by recording an adjustment to the provision, and a corresponding adjustment to property, plant and equipment. The unwinding of the discount on the decommissioning provision is included as a finance cost.

(m) Property, plant and equipment

Property, plant and equipment is stated in the Balance Sheet at cost less accumulated depreciation and any recognised impairment loss. Depreciation on property, plant and equipment other than production assets, is provided at rates calculated to write off the cost less estimated residual value of each asset on a straight-line basis over its expected useful economic life of between three and five years.

(n) Finance costs and debt

Borrowing costs directly attributable to the acquisition, construction or production of qualifying assets, which are assets that necessarily take a substantial period of time to get ready for their intended use or sale, are added to the cost of those assets, until such time as the assets are substantially ready for their intended use or sale.

Finance costs of debt are allocated to periods over the term of the related debt at a constant rate on the carrying amount. Arrangement fees and issue costs are deducted from the debt proceeds on initial recognition of the liability and are amortised and charged to the Income Statement as finance costs over the term of the debt.

(o) Share issue expenses and share premium account

Costs of share issues are written off against the premium arising on the issues of share capital.

(p) Taxation

Current and deferred tax, including UK corporation tax and overseas corporation tax, are provided at amounts expected to be paid using the tax rates and laws that have been enacted or substantially enacted by the balance sheet date. Deferred corporation tax is recognised on all temporary differences that have originated but not reversed at the balance sheet date where transactions or events that result in an obligation to pay more, or right to pay less, tax in the future have occurred at balance sheet date. Deferred tax assets are recognised only to the extent that it is considered more likely than not that there will be suitable taxable profits from which the underlying temporary differences can be deducted. Deferred tax is measured on a non-discounted basis.

Deferred tax is provided on temporary differences arising on acquisitions that are categorised as Business Combinations. Deferred tax is recognised at acquisition as part of the assessment of the fair value of assets and liabilities acquired. Any deferred tax is charged or credited in the income statement as the underlying temporary difference is reversed.

Petroleum Revenue Tax (PRT) is treated as an income tax and deferred PRT is accounted for under the temporary difference method. Current UK PRT is charged as a tax expense on chargeable field profits included in the Income Statement and is deductible for UK corporation tax.

(q) Pensions

Contributions to the Group's defined contribution pension schemes are charged to operating profit on an accruals basis.

(r) Derivative financial instruments

The Group uses derivative financial instruments to manage its exposure to fluctuations in foreign exchange rates, interest rates and movements in oil and gas prices.

Derivative financial instruments are stated at fair value.

The purpose for which a derivative is used is established at inception. To qualify for hedge accounting, the derivative must be 'highly effective' in achieving its objective and this effectiveness must be documented at inception and throughout the period of the hedge relationship. The hedge must be assessed on an ongoing basis and determined to have been 'highly effective' throughout the financial reporting periods for which the hedge was designated.

(r) Derivative financial instruments continued

For the purpose of hedge accounting, hedges are classified as either fair value hedges, when they hedge the exposure to changes in the fair value of a recognised asset or liability, or cash flow hedges, where they hedge exposure to variability in cash flows that is either attributable to a particular risk associated with a recognised asset or liability or forecasted transaction.

In relation to fair value hedges which meet the conditions for hedge accounting, any gain or loss from re-measuring the derivative and the hedged item at fair value is recognised immediately in the Income Statement. Any gain or loss on the hedged item attributable to the hedged risk is adjusted against the carrying amount of the hedged item and recognised in the Income Statement.

For cash flow hedges, the portion of the gains and losses on the hedging instrument that is determined to be an effective hedge is taken to equity and the ineffective portion, as well as any change in time value, is recognised in the Income Statement. The gains and losses taken to equity are subsequently transferred to the Income Statement during the period in which the hedged transaction affects the Income Statement or if the hedge is subsequently deemed to be ineffective. A similar treatment applies to foreign currency loans which are hedges of the Group's net investment in the net assets of a foreign operation.

Gains or losses on derivatives that do not qualify for hedge accounting treatment (either from inception or during the life of the instrument) are taken directly to the Income Statement in the period.

(s) Leases

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership to the lessee. All other leases are classified as operating leases and are charged to the Income Statement on a straight-line basis over the term of the lease.

Assets held under finance leases are recognised as assets of the Group at their fair value or, if lower, at the present value of the minimum lease payments, each determined at the inception of the lease. The corresponding liability to the lessor is included in the Balance Sheet as a finance lease obligation. Lease payments are apportioned between finance charges and reduction of the lease obligation so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are charged directly against income, unless they are directly attributable to qualifying assets, in which case they are capitalised in accordance with the Group's policy on borrowing costs.

(t) Share-based payments

The Group has applied the requirements of IFRS 2 Share-based payments. In accordance with the transitional provisions of that standard, only those awards that were granted after 7 November 2002, and had not vested at 1 January 2005, are included.

All share-based awards of the Company are equity settled as defined by IFRS 2. The fair value of these awards has been determined at the date of grant of the award allowing for the effect of any market-based performance conditions. This fair value, adjusted by the Group's estimate of the number of awards that will eventually vest as a result of non-market conditions, is expensed uniformly over the vesting period.

The fair values were calculated using a binomial option pricing model with suitable modifications to allow for employee turnover after vesting and early exercise. Where necessary, this model was supplemented with a Monte Carlo model. The inputs to the models include: the share price at date of grant; exercise price; expected volatility; expected dividends; risk free rate of interest; and patterns of exercise of the plan participants.

(u) Financial assets

All financial assets are recognised and derecognised on a trade date where the purchase or sale of a financial asset is under a contract whose terms require delivery of the investment within the timeframe established by the market concerned, and are initially measured at fair value, plus transaction costs.

Financial assets are classified into the following specified categories: financial assets 'at fair value through profit or loss' (FVTPL); 'held-to-maturity' investments; 'available-for-sale' (AFS) financial assets; and 'loans and receivables'. The classification depends on the nature and purpose of the financial assets and is determined at the time of initial recognition.

(v) Cash and cash equivalents

Cash and cash equivalents comprise cash on hand and demand deposits, and other short-term highly liquid investments that are readily convertible to a known amount of cash and are subject to an insignificant risk of changes in value.

(w) Loans and receivables

Trade receivables, loans, and other receivables that have fixed or determinable payments that are not quoted in an active market are classified as loans and receivables. Loans and receivables are measured at amortised cost using the effective interest method, less any impairment. Interest income is recognised by applying the effective interest rate, except for short-term receivables when the recognition of interest would be immaterial.

(x) Effective interest method

The effective interest method is a method of calculating the amortised cost of a financial asset and of allocating interest income over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash receipts (including all fees on points paid or received that form an integral part of the effective interest rate, transaction costs and other premiums or discounts) through the expected life of the financial asset, or, where appropriate, a shorter period.

Income is recognised on an effective interest basis for debt instruments other than those financial assets classified as at FVTPL. The Group chooses not to disclose the effective interest rate for debt instruments that are classified as at fair value through profit or loss.

(y) Financial liabilities and equity

Financial liabilities and equity instruments are classified according to the substance of the contractual arrangements entered into.

(z) Equity instruments

An equity instrument is any contract that evidences a residual interest in the assets of the group after deducting all of its liabilities. Equity instruments issued by the Group are recorded at the proceeds received, net of direct issue costs.

(aa) Other financial liabilities

Other financial liabilities, including borrowings, are initially measured at fair value, net of transaction costs. Other financial liabilities are subsequently measured at amortised cost using the effective interest method, with interest expense recognised on an effective yield basis. The effective interest method is a method of calculating the amortised cost of a financial liability and of allocating interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments through the expected life of the financial liability, or, where appropriate, a shorter period.

(ab) Critical accounting judgements and key sources of estimation uncertainty

Details of the Group's significant accounting judgements and critical accounting estimates are set out in these financial statements and include:

- Carrying value of intangible exploration and evaluation fixed assets (note 9);
- Carrying value of property, plant and equipment (note 10);
- Commercial reserves estimates (note 10);
- Presumption of going concern (note 16);
- Derivative financial instruments (note 17);
- Decommissioning costs (note 20); and
- Recoverability of deferred tax assets (note 20).