
- Round One Contracts - Environmental Obligations Overview

Round One tender process began on December 11, 2014, which is the procedure through which the National Oil and Gas Commission (Comisión Nacional de Hidrocarburos) (“CNH”) offers to the private sector 169 areas for oil and gas extraction and exploration projects in deep waters, shallow waters and for non-conventional resources (shale gas), through a number of tenders. In this regard, within the Round One tender process, the CNH has issued 3 invitations to bid, two under the shared production structure and one through the license contracting format.

We will outline the environmental requirements and obligations that contractors will have to observe according to the shared production model and the license model contract, as well as under the applicable environmental laws.

Below, we will divide the environmental obligations of contractors into two sections. The first section will address the environmental obligations of contractors that are common to both the shared production and the license model contracts and the second section will address the obligations of only the shared production model contracts, whether they are only for extraction or if they include exploration.

(i) Common obligations in shared production and license contracts

The contracts comprise different stages related to the extraction and/or exploration in each of the contractual areas subject to the tenders. The stages for the development of the contracts are the following: (i) exploration (if applicable); (ii) appraisal; (iii) development; (iv) production; and (v) abandonment.

In relation to the above, the shared production contracts and licenses, when they are for both exploration and extraction, and those only for extraction, contemplate the following common environmental obligations for the contractors.

Development Stage

The CNH may issue observations when the draft of the development plans presented by the contractor during the development stage (i) are not consistent with the environmental standards, and with them a higher environmental risk is assumed that is not acceptable under the current regulations; (ii) when the proposed mechanisms or instruments to be used can harm the environment; or (iii) when an adverse impact can be caused to the environment. The contractor will then propose operational solutions and the corresponding adjustments to the development plan in order to address the observations of the CNH.

No penalty is established for failure to comply with the observations of the CNH on the development programs in either the Oil and Gas Law or in the model contract. Nevertheless, in the model contract a form of conciliation

procedure is established through hearings or meetings between the contractor and the CNH during which any technical difference between the observations of the CNH and the development plans shall be clarified in good faith.

Additionally, within this development stage, the contractor must provide to the CNH, within 10 business days following the end of each quarter, a performance report in relation to industrial safety, operational safety and environmental protection, based on the indicators of the management system of each contractor and those determined by the National Agency of Industrial Safety and Environmental Protection of the Oil and Gas Sector (Agencia Nacional de Seguridad Industrial y de Protección al Medio Ambiente del Sector Hidrocarburos) ("ASEA").

The ASEA is the decentralized body of the Ministry of Environment and Natural Resources (Secretaría de Medio Ambiente y Recursos Naturales) ("SEMARNAT") created through the recently enacted Law of the National Agency of Industrial Safety and Environmental Protection of the Oil and Gas Sector, published in the Federal Official Gazette on August 11, 2014. The main functions of the ASEA are the regulation and supervision of industrial and operational safety and environmental protection of the oil and gas facilities and activities, specifically those for dismantling and abandonment of sites in the oil and gas sector. Additionally, it will be responsible for the integrated control of the hazardous waste and emissions of the sector.

Production Stage

No later than 180 calendar days before the production stage begins, the contractor must propose to the CNH the delivery and reception procedure plan of the oil and gas that will govern the programming, storage, measurement, and monitoring of quality of the oil and gas delivered and consider environmental protection measures at all times.

Moreover, the contracts also consider as an obligation, including for subcontractors, the adoption of appropriate measures to protect the environment, in accordance with the management system of each contractor and the applicable regulations. In that regard, they will also be obligated to execute the emergency response plans established in the management system of each contractor in emergencies and acts of God or force majeure that cause or may cause damage to the environment.

Site Abandonment Stage

During the site abandonment stage, every contractor is obligated to properly plug wells before abandoning them in order to avoid contamination, damages to the environment, or possible damages to the oil and gas deposits.

It is important to mention that each contract contains a specific clause referring to environmental and industrial safety liability which establishes that the contractor shall:

- Carry out the oil and gas activities in an environmentally sustainable manner, preserving and conserving the environment and maintaining the best conditions that permit sustainable development;
- Perform all the environmental studies and obtain, renew, and maintain in force all the environmental permits issued by the competent authorities for engaging in oil and gas activities, in accordance with the

applicable regulations, which is to say the environmental impact authorization, the risk study, the civil protection programs and the hazardous waste permits and authorizations, among others. Within Annex 4 of each contract, the CNH provides a list of the various studies, plans, and programs the contractors will have to complete in each stage of the contracts;

- Comply with all the conditions established in the environmental permits;
- Use qualified personnel, materials, operational procedures, and in general the most up-to-date technologies that comply with the best practices of the industry, applying the principle of prevention, precaution and preservation of biological diversity, natural resources and the health and safety of the community and of its personnel;
- Be liable for any adverse effects on the environment, and their corresponding remediation during the term of the contract in accordance with the Federal Environmental Liability Law (Ley Federal de Responsabilidad Ambiental) (“LFRA”). In the event of environmental damage caused by the oil and gas activities, the contractor and subcontractor shall immediately carry out the works for controlling the polluting effects in terms of the General Law for the Prevention and Integrated Management of Waste (Ley General para la Prevención y Gestión Integral de los Residuos) (“LGPGIR”) and its Regulation. Although it seems that in the specific environmental obligations clause the degree of specific liability of contractors and subcontractors is not defined and that both will be jointly and severally liable, in other contract clauses it is expressly established that the contractor will be responsible for complying with all the environmental obligations, commitments, and conditions and liable for the damages it causes to the environment in carrying out the oil and gas activities. Similarly, within the same contract it is established that the contractor shall implement all the measures necessary to verify that the subcontractor complies with all its environmental obligations. Consequently, the contractor will be held liable in first instance, however subcontractors will also be held liable.
- Collaborate with the ASEA and the State bodies responsible for the sustainable development of the contractual area, giving the personnel of the ASEA access to all the facilities, timely delivering to the ASEA all the information and documentation requested in relation to its jurisdiction, and appear before the ASEA when requested in accordance with the applicable regulations;
- As part of the activities of the abandonment stage, remediate and rehabilitate the contractual area that is being abandoned and comply with all the environmental obligations that may exist as a result of the oil and gas activities, which we presume will be contemplated from the beginning of the activities within the environmental impact authorization.

In case of emergency or accidents that require immediate action, the contractor shall immediately inform the CNH, the ASEA and the Ministry of Energy, and take all appropriate measures according to the emergency response plan of the management system of each contractor in order to control the situation as soon as possible.

Furthermore, the contractor will indemnify and hold the CNH and any other governmental agency, as well as their employees, harmless from any liability resulting from any action, claim, proceeding, or lawsuit arising from any damages or lost profits suffered for losses or contamination caused by the contractor, or any subcontractor, to the oil and gas or any damage caused to the natural resources and environment, including but not limited to damage to or destruction of marine resources, wildlife, oceans, or the atmosphere and any damages that may be recognizable and payable under the LFRA.

It is important to mention the provisions of article 19 of the Oil and Gas Law, which provides that the liability of the contractor will be calculated according to best international practices. This concept seems to leave the environmental liability of the contractor very open, since the authority would be able to choose the international practice it wishes for this purpose. Notwithstanding the above, we consider that any liability should be calculated according to the LFRA, since this is the special law within the national legal framework that should apply regarding environmental liability matters.

Finally, the contracts establish that any work program relative to the activities in the appraisal stage shall contain environmental studies to be done in order to determine recovery factors, as well as requirements for processing and transportation of the oil and gas of the discovery, and safety and environmental protection measures.

It is important to emphasize in general the basic scope of the LFRA, the primary purpose of which is the protection, preservation, and restoration of the ecological balance and the environment, and to guarantee the human right to a healthy environment for the development and wellbeing of everyone.

This law is the only law that establishes punitive sanctions specifically for damages to the environment, in addition to those provided for through administrative, civil or criminal proceedings, such as: (i) remediation and, if applicable, environmental compensation; (ii) economic sanctions which can reach approximately MXN\$42'000,000.00 pesos; plus (iii) the payment of the expenses incurred by the claimant to prove the environmental liability of the defendant; among others.

Furthermore, the LFRA establishes that the entities will be liable for the environmental damages caused by their representatives, administrators, managers, directors, employees, when they order or consent to the harmful conduct. The statute of limitations on the action to claim environmental liability is now 12 years, counting from the time at which the environmental damage is produced, while prior to the LFRA (2012), the statute of limitations was 5 years.

(ii) Specific obligations for each type of contract

a) Specific obligations in shared production contracts

In these types of contracts it is mentioned that the CNH may issue observations relative to the exploration plan that each of the contractors submit, when they do not draft the plan in accordance with the best practices of the industry for the evaluation of oil and gas potential, including environmental and industrial workplace safety and health standards. Once the observations are issued, the contractor will be the one who proposes the relevant operational solutions and adjustments to the exploration plan in order to address the observations of the CNH.

b) Specific obligations in extraction contracts in the shared production scheme

In these types of contracts, following their signature, a stage will begin known as the startup transition stage which will have a duration of up to 90 calendar days. In this stage the contractual area will be delivered to the contractor by the CNH or a third party designated for that purpose. Specifically, in relation to environmental obligations, the contractor must initiate the studies, according to the guidelines ASEA issues for this purpose,

that allow for the identification, characterization, and prediction of environmental liabilities, in order to establish the environmental baseline prior to initiating the oil and gas activities.

When those studies are finished, or no later than 90 days after the date of termination of the startup transition stage, the contractor must present a detailed report on the environmental baseline, and notify the CNH and the ASEA of any preexisting damage, which is to say the environmental liabilities present in the contractual area that were identified in the environmental baseline. The State will ensure that any previous contractor contracted prior to the date on which the various contracts are signed, assumes the expenses related to the liquidation, cleanup, and remediation of the preexisting environmental liabilities.

When the startup transition stage is completed, the contractor will assume full responsibility over the contractual area and over the wells and materials found in it, except for those liabilities that have been identified in the studies mentioned in the above paragraph.

Prior to the initiation of the oil and gas activities, the contractor must obtain and maintain in full force and effect the insurance policies covering civil liability for damages to third party property or personal injury, including civil environmental liability which covers damages to the environment from oil and gas pollution.

The Contractor will provide to the CNH, within ten business days following the end of each quarter, a report summarizing the compliance of the contractor and the subcontractors with the procedures of operational reliability, safety, health and environmental protection.

Finally, during the final transition stage the contractor must update the environmental baseline, in order to identify the existing environmental liabilities resulting from the oil and gas activities in all or the corresponding part of the contractual area.

To obtain additional information contact our experts:

Edmond Grieger, Partner:

+ 52 (55) 5258-1048, egrieger@vwys.com.mx

Ariel Garfio, Associate:

+ 52 (55) 5258-1008, agarfio@vwys.com.mx

Fernanda Martínez, Lawyer:

+ 52 (55) 5258-1008, fmartinez@vwys.com.mx

Sincerely,

Von Wobeser & Sierra, S.C.

Mexico City, July 16th, 2015.