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MEXICAN LEGAL NEWS

## *Energy Reform Round One Bids for the Oil and Gas Sector*

Articles 27 and 28 of the Constitution and transitory articles 5, 6, 7 and 8 of the Energy Reform approved in December 2013, establish that the private sector can participate in the extraction and exploration of oil and gas under the procedure that the State determines. In this regard, on December 11, 2014, the National Oil and Gas Commission (Comisión Nacional de Hidrocarburos) ("CNH") issued the rules for the first bid of 14 contractual areas of Round One.

Round One is the procedure through which the CNH will offer to the private sector 169 areas for engaging in oil and gas extraction and exploration projects in deep waters, in shallow waters and for unconventional resources (shale gas, also known as *gas de lutitas*), of which 109 correspond to exploration projects and 60 to extraction projects. These areas represent an approximate area of 28,500 Km<sup>2</sup> of which 90% corresponds to exploration areas and 10% for extraction, representing a volume of 3,782 and 14,606 million barrels of crude oil equivalent (MMbpce), respectively, and it is expected to represent annual investments of approximately \$8,525 million dollars between 2015 and 2018. Also contemplated in this Round One are the so-called farm-outs, which will be the conversions that PEMEX can make of the assignments granted to it through Round Zero, to contracts with the private sector by a bidding process and with prior approval of the Ministry of Energy (Secretaría de Energía) ("SENER").

In spite of the above and the great international interest in investing in these areas, the current international market presents certain uncertainties in relation to the possibility of investment in these contractual areas. This is the result of the fact that the price of a barrel of oil is currently low, fluctuating around USD \$40.00 per barrel; however, market expectations are that the price of a barrel of oil will be established around mid-June and July of 2015, which will allow for a better panorama for obtaining the contractual areas of Round One, principally those regarding the exploitation of unconventional resources. According to the information provided by SENER, it is intended to bid almost 90 areas for exploration and extractions of shale gas, and therefore the Federal Government has decided to delay the publication of invitations to bid in these areas until mid 2015, given that their operational success depends directly on the market and oil prices.

Companies dedicated to the exploration and extraction of these unconventional resources, primarily in the United States, have been going through complicated times, due to the decrease in oil prices, the high cost of the exploration and extraction of *shale gas* and *shale oil* through the technique known as hydraulic fracturing (*fracking*), the exhaustion of the richest deposits of these unconventional resources in the United States, and the decrease in the expected productive life of deposits of this kind.



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In light of the above general panorama and background, the CNH based on the Administrative Provisions in relation to Bids for Contracts for Oil and Gas Exploration and Extraction, published on November 28, 2014, issued the first invitation to bid in this Round One, which contemplates the bid for 14 contractual areas in shallow waters, through the model shared production contract both individually and for associations. The bidding process, the rules of this invitation to bid and the model contracts have the following basic characteristics:

### Critical dates:

- The period to request access to the data room and pay MXN \$5'300,000.00 in order to have access, will be from December 11, 2014 to March 16, 2015, and access to the data room will be provided from January 15 to July 14, 2015.
- All those interested may register up to March 31 paying the amount of MXN \$280,000.00.
- The winner of the bid will be declared before July 17, and the contract will be signed before August 21, 2015.

### Forms of participation:

- The participation in this bidding process and in the execution of the contracts for the exploration and extraction of oil and gas may be individual, in consortium or in a profit-sharing agreement.
- The association is free, for both Petróleos Mexicanos ("**Pemex**") and for the other interested companies, upon presenting proposals in the bids to obtain a contract.
- Once the contract has been awarded by the bidding process, the winner may freely change the capital structure or even the operator, as many times as necessary, as long as it has the authorization of CNH.

### Design of the contract:

- SENER will be responsible for selecting the areas for contract bidding with the technical assistance of CNH.
- The technical guidelines for establishing the bidding rules, including the criteria and the pre-qualification process, will also be the responsibility of SENER. For this it must obtain the opinion of the Federal Economic Competition Commission (Comisión Federal de Competencia Económica) ("**COFECE**") on the pre-qualification criteria and the award mechanism; it may be any of those commonly used at the international level.
- SENER will also determine and design the type of contract that will apply to each contractual area, following an opinion from the Ministry of Finance and Public Credit (Secretaría de Hacienda y Crédito Público) ("**SHCP**"). In addition, SHCP will be responsible for determining the economic-fiscal terms of the contracts, as well as the award variables that will be economic.



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### **Bidding Process:**

CNH will be responsible for carrying out the bids to award the contracts previously designed for the exploration and extraction of oil and gas, following the technical guidelines of SENER and the economic-fiscal conditions that SHCP establishes.

CNH will sign the contracts with the winner of the bid, whether Pemex, a private company, or Pemex associated with private companies.

### **Operation:**

- CNH will approve the plans for exploration and extraction and is responsible for authorizing the drilling of wells.
- The National Agency for Industrial Security and Environmental Protection (Agencia Nacional de Seguridad Industrial y de Protección al Medio Ambiente) ("**ASEA**") will be responsible for supervising and sanctioning the contractors in relation to the protection of people, assets and the environment. In this regard, the issuance of guidelines by ASEA to regulate the activities of the contractors is still pending. However, according to the transitory articles of the ASEA Law, until this Agency begins operations and issues the guidelines, those established by the Ministry of Environment and Natural Resources (Secretaría del Medio Ambiente y Recursos Naturales) ("**SEMARNAT**") in oil and gas matters will be followed.

### **Administration of the oil and gas income:**

- The Mexican Oil and Gas Fund for Stabilization and Development (Fondo Mexicano del Petróleo para la Estabilización y el Desarrollo) ("**FMPED**") will be responsible for receiving all the income, making the payments as established in each contract and administering the resources corresponding to the State.

### **Farm-Outs:**

- The same bidding procedure applicable to exploration and extraction will apply, with some exceptions. Such procedure shall be applied equally by CNH to guarantee the best conditions for the State. However, Pemex must give a favorable opinion on the pre-qualification criteria designed by SENER and provide its opinion on the companies that are pre-qualified in the bid and likewise CNH will be responsible for declaring the winner.
- Once this market process is carried out, Pemex may adjust the company according to its convenience, but with CNH's authorization.



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Bidding rules:

Technical capacities to be able to participate in the bid:

- Proven experience as operator in the period 2010-2014, notwithstanding that the project has initiated before or ended within this period:
  - For at least three exploration and extraction projects at the international level; or
  - Investments of capital in exploration and extraction projects that altogether are at least one billion dollars.
- Having been the operator on at least one offshore exploration and extraction project, or having participated as partner in at least two offshore exploration and extraction projects, in the last five years;
- Have personnel with at least 10 years of managerial and operational experience, in the handling of offshore exploration and extraction projects; and
- Experience in matters of industrial safety and environmental protection during the last five years.

Financial capacities to be able to participate in the bid:

- Demonstrate net worth of at least one billion dollars. If part of a consortium, the operator must demonstrate at least 600 million dollars, and
- Alternatively, demonstrate having total assets with a value of at least 10 billion dollars, and demonstrate having an investment grade credit rating according to the primary rating agencies.

Additional capacities to be able to participate in the bid through consortium:

- Demonstrate net worth of at least one billion dollars; such amount must be reached with no more than three members of the consortium;
- The operator must hold at least one third of the economic share of the consortium; and
- No other member of the consortium may have an economic share greater than the operator.

Specific rules for the participation of consortiums:

- No company may participate in more than one consortium. Consortium is understood as two or more companies that participate jointly in the bid, without thereby being required to incorporate a new legal entity in accordance with the law applicable to oil and gas matters;
- A large scale company criterion is established (1.6 MMbpced). These companies may not join to form consortiums. This restriction will not apply in deep waters, extra-heavy oils and unconventional oil and gas deposits; and
- The companies or consortiums may present economic proposals for up to five contractual areas.



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### Principal Aspects of the Shared Production Model Contract:

For this first stage of bidding, the use of the model shared production contract is established, which was published on December 11, 2014 on the official web page of CNH and which was prepared based on the provisions of the Oil and Gas Law, the Coordinated Energy Regulatory Bodies Law, and in the corresponding Administrative Provisions, the principal aspects being the following:

- **Special characteristics:** A maximum period of 5 years for the exploration and a minimum work commitment depending on the contractual area. It provides for the gradual reduction of undeveloped areas from the third year of exploration and a rent per km<sup>2</sup> of the undeveloped area of exploration if delivered voluntarily.
- **Exploration plan:** The contractor shall present to CNH the exploration plan, which shall contain at least the minimum work program during the initial exploration period.
- **Development Plan:** In case of any commercial discovery the contractor must present to CNH the development plan which must contain at least the adequate methods and processes to obtain the maximum factor of recovery of the reserves, as well as the work program for the development period.
- **Term:** The duration of the contract will be for 25 years with the possibility of two extensions of five years each.
- **Administrative rescission:** The administrative rescission by CNH is established in accordance with the Oil and Gas Law; we mention the following causes:
  - More than 180 continuous calendar days pass without the contractor initiating the activities established in the exploration plan or in the development plan in the case of commercial discovery;
  - The contractor does not comply with the minimum work plan without a justified cause; and
  - A serious accident occurs caused by fraud or negligence of the operator or a participating company, which causes damage to the facilities, fatality and loss of production.
- **Contractual rescission:** In addition to administrative rescission, contractual rescission by CNH is provided for, for reasons such as:
  - The contractor does not present the exploration performance bonds or the corporate guarantees or does not keep them in force;
  - The contractor hides relevant information or sends false information to the competent authorities with respect to production or costs; and
  - Any of the companies participating infringe any provision contained in the anticorruption and conflicts of interest clause.





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- **Conciliation:** In case of any dispute arising between the parties, before initiating any proceeding, the parties will try to resolve it through conciliation.
- **Federal Courts:** Any dispute between the parties that is not resolved in conciliation and that is related to causes of administrative rescission, shall be resolved before the Federal Courts of Mexico.
- **Arbitration:** Any dispute other than those arising for causes of administrative rescission that have not been resolved three months after initiating the conciliation procedure, may be resolved by arbitration according to the Rules of Arbitration of the United Nations Commission on International Trade Law.
- **Assignment:** Any sale, assignment, transfer or transmission of the rights or obligations of the contract must have the authorization of CNH. In case of total assignment of the interest, the acquiring party will be jointly and severally liable for the obligations of the contract.
- **Joint and several liability:** All the companies that participate in consortium are jointly and severally liable for fulfillment of each and every one of the obligations of the contract.
- **Budgets:** The contractor must present for the approval of CNH, a budget of the costs to incur with the implementation of each work program.
- **Ownership and use of materials:** During the term of the contract, the contractor will maintain ownership of all the materials generated or acquired to be used in the exploration and extraction activities. At the end of the contract the ownership of such materials will automatically pass to the Nation without any cost.
- **Additional obligations of the contractor:**
  - Obtain all the permits necessary to carry out the oil and gas exploration and extraction activities;
  - Be up to date with respect to its tax obligations; and
  - Ensure that the oil and gas discovered does not spill or is not wasted in any form and avoid damages to the oil and gas strata and to those that contain water.
- **Consideration:** From when the contractor begins the production and delivers the oil and gas, FMPED will make monthly payments for both the State and the contractor. The state will receive the contractual fee for the exploratory phase, the royalties and the percentage of operating profit according to each contract. Those of the contractor will be the recovery of the costs and the remaining percentage of the operating profit according to the criteria of each contract.
- **Guarantees:** The contractor shall present in due time and form according to the contract, a performance bond for exploration and a corporate guarantee to guarantee the proper and full compliance with the obligations of the contractor.



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- **National Content:** During the exploration period the contractor must comply with the 13 % national content minimum in the items indicated by the methodology of the Ministry of Economy (“SE”) that have been acquired or contracted for the oil and gas activities. In the development period there is a 25 % minimum in the items indicated by the SE methodology.
- **Insurance:** The contractor must obtain and maintain in effect insurance policies that the best practices of the industry require for engaging in exploration and extraction activities.
- **Indemnity:** The contractor must indemnify and hold CNH harmless from any action, suit, complaint or proceeding that is related to any of the premises established in the contract, such as among others:
  - Non-compliance with its obligations under the contract, except those where there are liquidated damages and the damages are limited thereto;
  - Any damage or harm to any person or the property of such persons arising from engaging in oil and gas activities; and
  - Any violation of the applicable law.

In conclusion, we can say that this first bidding phase referred to as Round One has the majority of the legal elements necessary to be able to award the contracts satisfactorily. Nevertheless, certain specific administrative guidelines have not yet been issued, such as those in relation to industrial safety, environmental protection and taxes, in order to provide full certainty to the companies that participate in these bidding procedures in the country.

*If you require additional information please contact our experts:*

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Sincerely,

***Von Wobeser & Sierra, S.C.***

Mexico City, January 26th, 2015.