Von Wobeser & Sierra
Mexican Legal News

Overview of the Model-Licensing Contract for the deep water exploration bid – 2016

The first draft of the model licensing contract for the 4th bid of Round 1 has been published on December 17th 2015 - time to take a look at the development of the presented provisions compared to those in the previous three bidding-rounds for a first and preliminary analysis.

The deep and ultra-deep water blocks to be awarded in this 4th bidding procedure provide for new technical and financial challenges much different from those faced in earlier bids (terrestrial and shallow water blocks). So far, the CNH (National Hydrocarbons Commission) has made use of both Model Licenses as well as Production Sharing Contracts. Comparing the existing regimes might offer new insights into the ongoing development and evaluation of the present model licensing contract.

Besides the contract term as the most basic of all contractual provisions in light of technical challenges, national content provisions should be in the spotlight, whereas financial challenges might rather be discussed with regards to financial and corporate guarantees. These deserve attention particularly in the current period of low and/or declining oil prices. Regarding the "established" criticism of earlier provisions for administrative rescission in connection with the dispute resolution mechanism, it will be interesting to review the current model-contract to see if any amendments have been done here.

a) Contract term

The lifetime or duration of the contract in general is 35 years split into three periods, namely exploration, evaluation and development (including production) and provides for an optional extension of up to 50 years.

Compared to previous Model Contracts, which had a contract term of around 40 years, this is a significant increase giving the investors the chance to increase their return on investment.

b) National Content Provision

According to the present version of the licensing contract, the percentages set forth in the national content provisions remain significantly below those we have seen in the previous model contracts, and appear to adapt to the technical challenges to be faced in deep and ultra-deep water operations, regarding the lack of experience among potential Mexican contractors in such operations. A minimum percentage of national content is established distinguishing between the different phases of operations.

For the exploration period, these are 3% during the initial exploration period, 6% during the first additional exploration period and 8% during the second additional exploration period. The same applies during the evaluation period. During the development period, the rate varies between 4% until and 10% from the start of commercial production. The following chart depicts the tremendous differences of the percentages of the known national content provisions of "Ronda Uno":

	Bid 1/2014	Bid 2 /2015	Bid 3/2015	Bid 4/2015
Exploration period	13 %	17 %	22 %	**3 – 8 %***
Development period	25 - 35 %	25 – 35 %	27 – 38 %	**4 – 10%****

* Initial Exploration period 3 %; 1st Additional Expl. period 6 %; 2nd Additional Expl. period 8 %

** Pre commercial production 4 %; Post commercial production 10 %

While the percentages in previous bids were ranging between 13% and 38%, it is now narrowed down to 3% to 10%. This can be interpreted as the reaction to the particularities of deep and ultra-deep water operations, and the fact that there is little know-how and equipment originating in Mexico.

c) Guarantees

In the previous bids the CNH has shown the willingness to react to criticism on the provisions establishing corporate and financial guarantees. In this first draft the guarantees comprise one to comply with the work program as well as a corporate guarantee. The latter is of particular interest, as it equals a rather high hurdle for interested investors: contractors are required to prove securities worth the equivalent of US$ 14 Billion in order to fulfil the obligatory guarantees, in the event that the contractor is not providing a corporate guarantee of its (ultimate) parent company.

Compared to the financial guarantees required in the 3rd bids, which required 300 million Dollars multiplied by the number of contracts in Type 2 Areas awarded to the Contractor as a result of the Bidding Process and 7.5 million Dollars multiplied by the number of contracts in Type 1 Areas awarded to the Contractor as a result of the Bidding Process, this is clearly a significant amendment to the contract.

While this is international standard for deep water and ultra-deep water operations, and due to the experiences made after the Macondo well disaster within the Gulf of Mexico might appear a sheer necessity, a side effect is that the scope of potential bidders is narrowed down significantly. This tendency is emphasised by the technical and financial requirements to prequalify for participating in the bids. Keeping in mind the somewhat "limited" interest in the previous shallow-water bids, this might prove to be a challenge for the present contract.

d) Administrative rescission

A clause that has been exposed to criticism in the previous bids is administrative rescission. Not only the broad and unspecified grounds for such had been addressed, but also the fact that administrative rescission had not been included into the arbitration clause within the contracts. In short it can be said, that with regards to this clause, the CNH so far has failed to comply with international standards.

However, taking a closer look at this clause, it is a positive signal sent by the CNH that (since the second bids) sub-paragraph (g) now defines the terms (i) "serious accident" (Accidente Grave), (ii) "without justifiable cause" (Sin Causa Justificada), (iii) "fault" (Culpa), (iv) "willful misconduct" (Dolo) and (v) "False or Incomplete Information or Reports" (Información o Reportes Falsos o Incompletos).

This arguably can be described as a step towards achieving compliance with international standards in terms of administrative rescission. Not only does the contract provide for a somewhat clearer picture when it comes to the grounds of administrative rescission. Far more important is the side-effect of narrowing down the scope of the grounds, which results in greater security for the contractors.

However, an issue that still needs to be addressed by the Mexican government is the fact that according to Articles 20 and 21 Hydrocarbons Law disputes arising from administrative rescission are not subject to arbitration but remain in the authority of Federal Courts. This limitation clearly applies to commercial arbitration. Yet, it does not necessarily do so for investment arbitration. While a limitation is implemented in the Trans-Pacific-Partnership (TPP), excluding Mexican consent to Investor State Arbitration with regards to disputes based on Article 20 and 21 Hydrocarbons Law in its Annex 9-L Subsection C, the NAFTA and various other Bilateral Investment Treaties (BIT) do not provide such reservation. Investment arbitration is a powerful and well established dispute resolution mechanism in international commerce. For interested investors it is therefore advisable to examine the applicable BIT and – if necessary – consider amendments to the domicile and place of incorporation of the entity undertaking the investment.

Conclusion

Questions that remain are of rather fundamental nature, e.g. why the CNH choses to apply and implement both Production Sharing- and Licensing Agreements, instead of sticking to one. However, the present contract is another step towards meeting international standards of licensing agreements. Nonetheless it might be beneficial to include further incentives for interested bidders, in order to make operations more attractive in times of weak oil prices and cuts in investments and exploration activities.

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Sincerely,

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