

Energy Alert

June 11, 2015

Mexico's Energy Industry

Ronda Uno, First Tender

On June 9, 2015, the Comisión Nacional de Hidrocarburos (“**CNH**”) published the final form of the Bidding Guidelines (“**Guidelines**”) and the Model Production Sharing Contract (“**PSC**”) for the First Tender initially published on December 11, 2014 (“**First Tender**”). Currently, 38 companies from around the world, grouped into 26 prequalified Individual and Consortium Bidders, will vie for 14 shallow-water Contract Areas located in the Gulf of Mexico. Even though the deadline to qualify as Individual and/or Consortium Bidders has passed, much action is yet to come, since (i) Consortia may add new financing partners or Individual Bidders to their groups, (ii) Operators may present bids with their Consortium partners or proceed as Individual Bidders, and (iii) Individual Bidders may still join a Consortium as an Operator or as a financing member (subject to prior notice requirements and the CNH's final approval). Capitalized terms not defined herein have the meanings ascribed to such terms in the Guidelines and PSC.

This email alert highlights the last changes in the final Guidelines and PSC, as well as a general overview of the most relevant features therein. The final Guidelines and PSC have significantly evolved since they were first published, mainly driven by an open dialogue between the Mexican government and international and domestic oil and gas companies, and the fluctuating global energy market conditions. Overall, while not perfect, it seems that these documents provide a fundamentally sound framework to analyze, prepare and present competitive bids, as well as to establish successful, productive and competitive exploration and production projects in Mexico for the next 30 years.

Timeline

The next steps are shown on the timeline below. Essentially, (i) the prequalified Consortium Bidders have until June 15 to request authorization to add non-prequalified Financing Partners, and (ii) the prequalified Consortium and Individual Bidders have until June 29 to request authorization to modify their structure or participation format. The CNH must communicate its final decision by July 6, in preparation for the Bidding Ceremony to be held on July 15.

Round 1.1 Bidding Process Timeline

- 6/09: CNH published **Final** Bidding Guidelines and Model PSC
- 6/15: Last day to request authorization to include new non-prequalified Financing Parties to Consortium
- 6/29: Last day to request authorization to change Consortium structure and interests
- 7/6: Last day for CNH to grant authorizations regarding non-prequalified Financing Partners and changes to Consortium structure and interests
- 7/14: Last day to access Data Room
- 7/15: Bid envelopes are presented, opened and Tender winners selected
- 7/17: CNH Resolution announcing Bid Winners is published in the National Gazette
- 8/21: Last day to execute the Exploration PSC

Summary of Key Changes in the Final Guidelines and PSC

- 1. Limit on Financial Partners' Participation:** Section 12.5 of the Guidelines now states that the Financial Partners must always hold less than two-thirds of the participating interests in the Consortium (the operator must always hold at least one-third of the total participating interests).
- 2. Measurement Points:** Updates to the corresponding definition and Clause 12 of the PSC confirmed that the Contractor will propose the location and operation of the Measurement Points, whether inside or outside of the Contract Areas, in compliance with Chapter 11 of the *Manual of Petroleum Measurement Standards*, subject to CNH's final approval.
- 3. Evaluation Program:** Article 5.2 of the PSC introduced a 60-day period after the CNH's receipt of the Contractor's Evaluation Program to analyze and communicate any comments/changes or its final approval, and a provision stating that such approval may not be denied without just cause.
- 4. Liability for Preexisting Damages:** Article 14.4 of the PSC now provides a detailed account of the full process the Contractor must undergo to avoid liability for any environmental Preexisting Damages. First, the Contractor must commence environmental studies during the Initial Transition Period (as defined hereafter). Second, it must notify the CNH and present all supporting information regarding any Preexisting Damages within 180 days from the Effective Date. Third, the CNH and the Agencia Nacional de Seguridad Industrial y de Protección al Medio Ambiente del Sector Hidrocarburos ("**Agency**") have a 60-day period to review the materials and object the Contractor's claims. If the Parties do not agree on what constitutes Preexisting Damages, they may hold good-faith meetings to clarify and settle any technical differences. Fourth, if approved, the CNH and the Agency will provide a certificate identifying the specific Preexisting Damages for which the Contractor shall have no liability or responsibility, and the obligation to complete Abandonment activities in accordance with Article 3.4. If no agreement is reached, the dispute will be resolved in accordance with Clause 26.
- 5. Limitations on Administrative Rescission:** Article 23.2, introduced in the May 29 version of the PSC, provided a series of substantive steps that the CNH must follow before commencing any formal administrative rescission process ("**Investigacion Previa**"). In this final version, an added provision allows the Contractor (i) to preemptively notify the CNH of any potential defaults or breaches of Contract

that could cause an administrative rescission and (ii) to propose a cure or solution before the Investigacion Previa is launched.

PSC Main Features

1. **Term:** The PSC has duration of 30 years, starting on the Effective (execution) Date. The Contractor has two five-year extension options, subject to additional terms and conditions to maintain commercial production.

2. **Initial Transition Period:** Article 3.4 calls for the CNH to deliver the assets and information it may have relating to the Contract Area within 90 days of the Effective Date ("**Initial Transition Period**"). During this period, the Contractor must commence social and environmental assessments to establish the baselines for the Contract Area and to identify any Preexisting Damages. Furthermore, the Contractor must inspect the assets made available in the Contract Area, and inform the CNH which assets it will retain and which assets should be abandoned or disposed by the previous operator. At the end of the Initial Transition Period, the Contractor will assume complete control and full responsibility for the Contract Area.

3. **Exploration Period:** The Initial Exploration Period lasts four years in which the Contractor is expected to complete the Minimum Work Program. The Additional Exploration Period is a two-year extension option that will be granted if the Contractor (i) has completed the Minimum Work Program (ii) commits to finish any missing units from the Increased Minimum Program, and (iii) pledges to carry out the work units equivalent to one Well during the extension period. Additionally, the Contractor must provide a new Performance Guaranty.

4. **Minimum Work Program:** The Minimum Work Program, reminiscent of the 2001 Multiple Services Contract model, is based on work units assigned to specific Petroleum Activities. The scheme assigns a minimum level of investment by linking a fixed amount of units per Petroleum Activity to the average price of oil per barrel. Therefore, the minimum investment is directly proportional to the price per barrel for a specific period; while the work units will remain constant, as the price per barrel increases, the minimum investment will also increase. The Minimum Work Program incentivizes Contractors to allocate resources into specific Petroleum Activities, such as drilling Wells and obtaining/processing seismic or G&G information.

5. **Evaluation Period:** The Evaluation Period will last 12 months, and an additional 12-month option can be requested if the development of the discovery is technically or commercially complex. The CNH must be informed of any commercial discoveries, and any Hydrocarbons extracted during the Evaluation Period shall be considered Regular Commercial Production, subject to the production-sharing and payment schemes.

6. **Nonassociated Gas or Sub-Salt Discoveries:** The PSC has special provisions for nonassociated gas and pre-salt discoveries. Article 5.4 provides that the Contractor has 24 months to evaluate a nonassociated gas discovery, with a 12-month extension option (the standard evaluation

period is 12 months). Similarly, Article 7.4 allows the CNH to give special consideration to pre-salt discoveries and grant additional time to evaluate the area if necessary.

7. Relinquishment: Clause 7 provides the different milestones at which the Contractor must relinquish percentages of the Contract Area based on its approved Evaluation and Development Programs.

8. Unitization: Clause 9 sets out a comprehensive approach to unitization. Contractors must first notify and provide information supporting unitization of Contract Areas to the Secretaria de Energia, the Secretaria de Hacienda and the CNH. These government entities have a set time-frame to assess the proposed unitization, request any additional information needed and issue their final decision. The Contractors will work with these entities and other Contractors to develop a unitization agreement that benefits all parties involved. Ultimately, the Minimum Work Program requirements will be reassessed, and operating duties will be assigned to maximize production and recovery of Hydrocarbons.

9. Payment and the Role of the Mexican Sovereign Wealth Fund (“Fondo”): The Fondo will provide a software program that shall interface with the Contractor’s software program to receive all production measurements and all expense information directly, including recoverable costs, to calculate the corresponding payments due to both the Contractor and the State. The Fondo will then provide the Contractor certificates of title for its share of Hydrocarbons. Annexes 3 and 11 provide clear steps on the payment process, as well as on the process to register the PSC, the parties involved in the Contract Area and the preferred payment methods with the Fondo. Even though the specific guidelines and the system are still under development, the PSC provides an outline of the Fondo’s role and its interaction with the Contractors.

10. Guarantees: The PSC requires Contractors to provide (i) an Exploration Performance Guaranty in the form of an irrevocable letter of credit for the estimated value of the applicable Minimum Work Program, (ii) an Additional Exploration Performance Guaranty (if applicable) and (iii) a Corporate Guaranty executed simultaneously by (a) the ultimate parent company or (b) a controlling entity within the same corporate group (“**Guarantor**”). The Guarantor must demonstrate a net worth of \$6 billion and notify the CNH if its net worth dips below this benchmark. In such case, the Contractor must provide a new Corporate Guaranty executed by a Guarantor that complies with the financial benchmark requirement.

11. Abandonment: The Contractor must create an Abandonment Trust and progressively fund it based on the formula provided in Article 18.4. At the term of the PSC, the Contractor must carry out social and environmental assessments, compare them to the initial baselines, and determine the environmental and social effects that the Petroleum Activities have had in the Contract Area. The Contractor must present an Abandonment Plan to access the Abandonment Trust funds, which may be used for only Abandonment activities.

12. National Content: Thirteen percent of the Materials or services contracted or acquired during the Exploration Period must be of Mexican origin. The national content requirements increase to 25 percent during the Development Period and must reach 35 percent by 2025.

13. Force Majeure: Article 22.3 provides that force majeure applies during the whole term of the PSC. However, Contractor's claims are limited to four contract extension periods of three months each due to force majeure. Under Article 22.4, both Parties have a right to terminate the PSC if an event of force majeure lasts for two (2) uninterrupted years.

14. Administrative Rescission: Administrative Rescission covers serious defaults, such as noncompliance with the Minimum Work Program without reasonable cause or unauthorized assignment of interests. Article 23.2 of the PSC provides that the CNH must carry out an administrative investigation process, specifically identifying its concerns and providing time for the Contractor to cure, before the Administrative Rescission process may begin. The CNH investigation may last anywhere from 30 days to two years, depending on the alleged administrative breach. Once the CNH finishes its investigation, it will give written notice of its findings and, if deemed necessary, commence the Administrative Rescission Process. It is important to note that the Contractor may cure any alleged default during this process, until the CNH issues its final decision.

15. Contractual Rescission: Article 23.4 covers instances such as the Contractor missing deadlines without reasonable cause beyond a certain grace period, not maintaining the Guaranties in due form or not completing 90 percent of the Minimum Work Program. It also provides the Contractor with 30 days to cure any breach after receiving written notice. Furthermore, some of the default provisions allow other members of the Consortium to substitute a member company or Guarantor in case one of the members is liquidated, becomes bankrupt or insolvent, or is otherwise unable to meet its obligations.

16. Dispute Resolution: All contractual disputes, including Contractual Rescission, might be resolved in the first instance through Conciliation, in accordance with Articles 26.2 and 26.3. If the Parties cannot reach an agreement, they must submit the contractual dispute to international Arbitration, in accordance with Articles 26.5 and 26.6. The Contractor must continue performing all of its applicable duties under the PSC and must waive the right to bring up any claims through diplomatic channels.

Contact Information

We have prepared a detailed analysis of the entire PSC contract form. If you are interested in receiving a copy of such materials, please do not hesitate to contact us at your convenience. If you have any questions regarding this alert, please contact:

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