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# Energy Alert

**August 28, 2015**

## Mexico's Energy Industry

### Final Model Contract and Bidding Guidelines Published for Ronda Uno, Second Tender

On August 25, 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 Second Tender initially published on February 27, 2015 ("Second Tender"). Currently, 20 companies from around the world, grouped into 14 prequalified Individual and Consortium Bidders, will vie for five shallow-water extraction areas located off the Gulf of Mexico coastlines of Veracruz, Tabasco and Campeche. The following is a list of the companies that have prequalified to participate in the Second Tender:

### Qualified Consortiums

| | |
|---|---|
| Eni International<br>Casa Exploration | Petronas Carigali<br>Galp Energia |
| Pan American Energy<br>E&P Hidrocarburos | Talos Energy<br>Sierra Oil & Gas<br>Carso Oil & Gas |
| Fieldwood Energy<br>Petrobal | |

### Qualified Individual Bidders

| | |
|---|---|
| Chevron | Lukoil |
| CNOOC | ONGC Videsh |
| CEPSA | Statoil |
| DEA Deutsche Erdoel | Shell |
| Plains Acquisition Corp. | |

Even though the number of qualified bidders is lower in comparison to the First Tender, many factors that will have a direct impact on this Second Tender have changed over the last three months, including the terms and conditions in the Model PSC and Bidding Guidelines. Despite all the changes affecting the Second Tender, the Mexican government has remained constant in its transparency and open-door policy, listening to industry comments and adjusting the process, as well as the Guidelines and Model PSC, to reflect the current investment environment in the energy sector. This client alert highlights the latest changes in the final Guidelines and Model PSC and provides a general overview of the most relevant features therein.

Overall, the final documents have made significant strides to provide a fundamentally sound legal framework for international and domestic oil and gas companies to analyze, prepare and present bids in the short term, but with an eye to develop long-term, mutually beneficial relationships in a highly competitive environment. Capitalized terms not defined herein have the meanings ascribed to such terms in the Guidelines and PSC.

## Timeline

The next steps are shown on the timeline below. Essentially, (i) the prequalified Consortium Bidders have until September 11 to request authorization to add nonprequalified Financing Partners, and (ii) the prequalified Consortium and Individual Bidders have until September 18 to request authorization to modify their structure or participation format. The CNH must communicate its final decision by September 25, in preparation for the Bidding Ceremony to be held on September 30.

**Round 1.2 Bidding Process Timeline**

- **8/25**: CNH publishes **Final** Bidding Guidelines and Model PSC
- **9/11**: Last day to request authorization to include new non-prequalified Financing Parties to Consortium
- **9/18**: Last day to request authorization to change participation format, Consortium structure and interests
- **9/25**: Last day for CNH to grant authorizations regarding non-prequalified Financing Parties and changes to Consortium structure and interests
- **9/29**: Last day to access Data Room
- **9/30**: Bid envelopes are presented, opened and Tender winners selected
- **10/02**: CNH Resolution announcing Bid Winners is entered for publication in the National Gazette
- **11/06**: Last day to execute the Exploration PSC (or 90 days from the adjudication of the contract)

## Summary of Key Changes in the Final Guidelines and Model PSC

**1. Bid Guaranty:** Section 13.4(b) of the Guidelines states that the Contractor must present one Stand-By Letter of Credit worth $1 million with a 90-day term. This Letter of Credit will now cover offers submitted by a Bidder for one or more Contract Areas.

**2. Minimum State Share:** Secretaria de Hacienda will release the Minimum State Shares on September 14, providing Prequalified Bidders with additional time to process the information and prepare competitive bids.

**3. Evaluation Plan:** Revised Article 4.1 of the Model PSC increased the period of time to present the Evaluation Plan from 60 to 90 days after the Effective Date.

**4. Pre-existing Damages:** Article 13.4 of the Model PSC now provides the Contractor with 180 days from the Effective Date to carry out its environmental and social baseline assessments. The Contractor may request a 90-day extension to complete the assessments, subject to the CNH's approval.

**5. Corporate Guaranty:** Article 16.2 of the Model PSC states that each Participating Company must provide only a Corporate Guaranty for its proportional participation in the Consortium when its ultimate Parent Company is not its Guarantor. Furthermore, each such Participating Company's Guarantor must show the CNH that its average annual net worth is at least 18 times the value of the Minimum Work Program. Finally, only one Corporate Guaranty will be required, even when the Contractor is awarded more than one Contract Area, in which case, the minimum net worth factor would be based on the highest valued Minimum Work Program.

**6.** **Insurance:** Article 19.2(d) of the Model PSC establishes specific financial requirements for the insurance coverage. The General Liability Policy must have a $700 million minimum cap, and the Well Control Policy must have $300 million minimum cap.

**7.** **Administrative Rescission:** Article 22 of the Model PSC underwent significant changes to address industry concerns and to provide legal certainty to the administrative rescission process and the Model PSC. Article 22.1(g) establishes and defines different standards that will help determine the just cause for an Administrative Rescission. For example, a just cause for an Administrative Rescission under Article 22.1(d) will come about only when an “Accidente Grave” or serious accident causes (1) such damage to the facilities that the Contractor is unable to carry out any Petroleum Activities in some or all the Contract Area for more than 90 days; (2) death <u>and</u> (3) a 25 percent drop on average per diem production for more than 30 days in comparison to the immediate prior semester. If the Accidente Grave causes all three consequences, then the CNH will carry out its Investigacion Previa to determine whether such serious accident was caused with “Dolo o Culpa,” which creates a standard of care similar to negligence in the United States, requiring the Contractor to know, or if it should have known, that the serious accident could occur. Another example includes Article 22.1(b), which provides that Administrative Rescission may take place when the Contractor does not comply with the Minimum Work Program “Sin Causa Justificada” or Without Just Cause. Such term is defined in 22.1(g)(ii) as any cause undoubtedly attributable to the Contractor for which the Contractor omitted carrying out reasonable efforts within its capacity to avoid breaching/noncomplying with the contractual obligations listed in Article 22.1; such reasonable efforts include notifying the CNH as soon as the Contractor knows that such a breach has occurred or is imminent.

Another very important modification to the Administrative Rescission process establishes that, at the end of the Investigacion Previa period under Article 22.2, if the Contractor considers it necessary, the Parties may jointly appoint an Independent Expert, in compliance to the requirements listed under Article 25.3, to help them determine, in a nonbinding manner, whether there is a just cause for Administrative Rescission and/or to remediate/cure the contract breach if possible.

**8.** Conciliator/Independent Expert: Article 25.3 now provides that the conciliator and/or the Independent Expert must at least have five years of experience in conciliation proceedings or the just cause for the Administrative Rescission.

**9.** Federal Tribunals and International Treaties: Article 25.4 establishes that the Contractor may commence an arbitration proceeding to determine applicable damages only if the Federal Tribunals in Mexico determine that there was no basis or just cause for the Administrative Rescission. Article 25.9 also provides that the Contractor shall have the rights and protections established in any bilateral trade agreements or free trade agreements executed by Mexico.

**10. Depth Restrictions:** Annex I provides the following depth restrictions for each Contract Area:

| Contract Area | Surface Area (km2) | Field(s) | Depth Restrictions |
|---|---|---|---|
| 1 | 67.2 | Amoca | No |
| | | Miztlon | No |
| | | Tecoalli A | No |
| | | Tecoalli B | Tecoalli -1001 |
| 2 | 39.6 | Hokchi A | 21.31 |
| | | Hockhi B | Cenozoic formations |
| 3 | 58.8 | Xulum | No |
| 4 | 58.0 | Ichalki | No |
| | | Pokoch | No |
| 5 | 54.9 | Mison | No |
| | | Nak | Cretaceous formations |
| Total | 278.51 | | |

## Model PSC Main Features

**1. Term:** The Model PSC has a duration of 25 years starting on the Effective (execution) Date. The Contractor has two five-year extension options, subject to additional terms and conditions, including maintaining commercial production levels.

**2. Initial Transition Period:** Article 3.4 calls for the CNH to deliver the assets and all information it may have relating to the Contract Area within 90 days of the Effective Date ("Initial Transition Period"). The Contractor must commence social and environmental assessments to establish the baselines for the Contract Area and to identify any Preexisting Damages within 180 days after the Effective Date ("Assessment Period"). The Assessment Period may be extended for an additional 90 days, subject to the CNH's approval. Furthermore, the Contractor must inspect the assets made available within the Contract Area, and inform the CNH which will it retain and which should be abandoned or disposed of by the previous operator (if applicable). At the end of the Initial Transition Period, the Contractor will assume complete control and full responsibility for the Contract Area.

**3. Evaluation Period:** The Initial Evaluation Period lasts two years, in which the Contractor is expected to complete the Minimum Work Program. The Additional Exploration Period is a one-year extension option that will be granted if the Contractor commits (i) to complete any missing units from the Minimum Work Program and/or the Increased Minimum Program, and (ii) to drill one more well. Additionally, the Contractor must provide a new Performance Guaranty. 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. Furthermore, Article 4.4 establishes that, if the Contractor fails to present the Evaluation Plan or the First Work Program in due time without just cause, it will be subject to a per diem fine calculated as follows:

$$\text{Penalty} = DR*[PMT/730]$$

Where: DR = Delay Days and PMT = Estimated Minimum Work Program Cost

Finally, the Contractor must submit a final evaluation report within 30 days after the end of the Evaluation Period.

**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 like drilling Wells and obtaining/processing seismic or G&G information.

**5. Relinquishment:** Clause 6 provides the different milestones at which the Contractor must relinquish percentages of the Contract Area based on its approved Evaluation and Development Programs.

**6. Unitization:** Clause 8 sets out the unitization process, which requires the Contractor to notify and provide supporting information to the CNH, who shall prepare its recommendation to *Secretaria de Energia*, who, in turn, will present a final report to *Secretaria de Hacienda*. These government entities have a set timeframe 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. If the contiguous area is not under contract, the Contractor must still undergo the same process, and *Secretaria de Energia* will determine the legal structure to carry out the unitization. If the Contractor does not comply with all the requirements in a timely manner, *Secretaria de Energia* will design the unitization program. Ultimately, the Minimum Work Program requirements will be reassessed, and operating duties will be assigned to maximize production and recovery of Hydrocarbons.

**7. New Exploration:** Article 5.5 provides the Contractor with the right to explore new plays or fields within the Contract Area, subject to the CNH’s approval.

**8. Financial Obligation:** Article 13.1(u) requires Contractors to maintain the same minimum net worth accredited during the Prequalification Process on an annual average basis.

**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 information systems to receive all production measurements and all expense information directly, including recoverable costs, to calculate the corresponding payments due to the Contractor and the State. The Fondo will then provide the

Contractor with certificates of title for its share of Hydrocarbons. Annexes 3 and 12 provide clear steps on the payment process, as well as on the process to register the Model 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 Model PSC provides an outline of the Fondo's role and its interaction with the Contractors.

**10. Guarantees:** The Model 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 the (a) ultimate parent company or (b) a controlling entity within the same corporate group ("Guarantor").

Article 16.1 of the Model PSC provides the Contractor with the right to request annual proportional adjustments to the Performance Guaranty based on its progress and compliance with the Minimum Work Program. This scheme will allow the Contractor much-needed financial flexibility as the Contract advances, because required reserve levels will decrease, effectively freeing cash and reducing the Contract's opportunity cost. Annex 6, Section 7 establishes the formula to calculate the amount of the Performance Guaranty in which the Work Units have been reduced by 50 percent. Details regarding the Bid Guaranty and the Corporate Guaranty are discussed in the previous section.

**11. Abandonment:** The Contractor must create an Abandonment Trust and progressively fund it based on the formula provided in Article 17.4. At the term of the Model 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 only for Abandonment activities.

**12. National Content:** Seventeen 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 21.3 provides that Force Majeure applies during the whole term of the Model PSC. However, the Contractor's claims are limited to four contract extension periods of three months each due to Force Majeure. Under Article 21.4, both Parties have a right to terminate the PSC if an event of Force Majeure lasts for two uninterrupted years.

**14. Administrative Rescission:** Administrative Rescission covers serious defaults like noncompliance with the Minimum Work Program Without Just Cause or a Serious Accident caused with "Dolo o Culpa." Details regarding the Administrative Rescission are discussed in the previous section.

**15. Contractual Rescission:** Article 22.4 covers instances like 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 cure the breach or substitute a member company/Guarantor in case they are liquidated, or become bankrupt, insolvent or otherwise unable to meet their obligations.

**16. Dispute Resolution:** All contractual disputes, including Contractual Rescission, might be resolved in first instance through Conciliation in accordance with Articles 25.2 and 25.3. If the Parties cannot reach an agreement, they must submit the contractual dispute to international Arbitration in accordance with Articles 25.5 and 25.6. The Contractor must continue performing all of its applicable duties under the Model PSC and must waive the right to bring up any claims through diplomatic channels.

## Contact Information

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