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Monday, 8th February
2010

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Pemex's promise

Published 2 February 2010

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David Enríquez, partner with Goodrich Riquelme y Asociados, analyses Mexico's energy reform and what Pemex needs to achieve to realise its potential



Pemex reservoirs have dramatically fallen since 2003. The production of Mexico's gigantic oil field, Cantarell, has decreased by 61 per cent representing a decline in Mexico's total output of 21 per cent. To make matters worse, Pemex operates with

technologically obsolete infrastructure and poor maintenance programmes, and its equipment has not seen substantial changes in the last two decades. Undoubtedly, Mexico's easy and cheap oil era has come to an end and the government needs to address the

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situation.

Pemex, along with the country's regulatory and legislative authorities, has begun working towards finding the best way to tackle this difficult scenario, especially in exploration and production (E&P).

The last two years has seen assessments into Pemex's productiveness, operational and execution capabilities, regulatory restrictions, and corporate governance. The studies concluded that in order for Pemex to maintain production levels in the short and long term, it was necessary to improve the average of proven reserves through the discovery of new fields, short-term new fields production and development of proven and probable reserve oil fields. Special concerns arose over potential deep-water fields since Pemex possesses neither the expertise nor the funds to explore them.

November 2008 marked a major step for Mexico's upstream industry in the last 60 years. A new pack of reforms were enacted by the government that aim to provide Pemex with an E&P legal regime closer to international oil-industry best practices.

The reform included the enactment of a new law addressing the corporate organisation of Pemex and its contracting practices, giving Pemex's board of directors an organic and an operative structure which resembles best international practices and includes independent professional experts. The board was granted greater administrative and management functions to improve its management, and technical operations will be carried out through seven different committees.

The reform also considered other government agencies such as the national hydrocarbons commission which has the technical capabilities and necessary knowledge to analyse Pemex's activities in depth, manage the exploitation plans and participate in the selection of technology. Its fundamental tasks will be to regulate and supervise hydrocarbons' exploration and exploitation, the refinery, storage, transport and distribution of oil and direct sales of the refined products. Natural gas or raw materials are excluded from this regulation.

The regulatory energy commission will approve and issue the terms and conditions to which first-hand sales of heavy oil, gas, and other basic petrochemicals shall be subject to. Also, it shall lay down the methodology for the determination of its prices, unless there are conditions of effective competition, and the terms and conditions to which the distribution of heavy oil, gas, other basic petrochemicals and the bioenergetics through pipelines are subject to.

Contractual forms

Previously Pemex E&P (PEP) was carried out through contractual forms that were inadequate by international standards. Contracting problems were mainly related to Mexico's bureaucracy and complex administrative regulations. Although some of these problems were addressed prior to the reform, the former contracting schemes still did not respond to the contractual needs of Pemex.

The federal government's objective through the 2008 reform aimed to

put upstream contracting schemes in line with the international outlook. The essential change is that upstream activities will no longer be subject to the public works law, but to commercial standards determined by the board of directors. Former contractual practices that were successful will remain as a key element for the development of new contractual forms being prepared in line with new E&P legal regime.

Some core features in the new forms are worth highlighting. Hydrocarbons and oil reserves will remain property of the nation; with Mexico maintaining at all times control over the direction of the oil industry. All contractual instruments are exclusively service agreements as opposed to production sharing or equivalent features, meaning no rights of preference for the purchase of oil and its derivatives will be awarded. Contract proposals can be submitted on behalf of an entire consortium, which in turn will designate a leader to communicate with PEP.

The work scheduled and its related budget, made annually by the bidder is known as an annual work programme (PAT). The PAT contract management group is composed of three PEP members and three contractor members and responsible for proposing, discussing and evaluating all those technical assistance activities for PEP, scheduling of works, coordinating PEP and bidders, applying performance indicators and other related matters. There is also a directive group comprised of three PEP members and two bidder members to resolve any topic related to the contract or any difference derived from the management group and may require the assistance of independent experts.

The bidder is required to submit a document issued by a certified rating agency registered before the National Banking and Securities Commission. Three different schemes may be planned, each one triggering different contractual and corporate responsibility. Amongst these are subcontracting (basic level), joint bid (intermediate level), and joint venture company (higher level). Depending on which requirements each company meets, several guarantees must be issued such as a corporate guarantee or performance bonds. Remuneration under the relevant agreements must be in cash, in line with the use and standards of the industry, a fixed amount or as a predetermined formula the outcome of which is a certain consideration.

Implementation

Although Pemex has been reluctant to publish works related to these new contractual forms, it is believed that they will be divided into contractual blocks related to deep waters and other models.

During the implementation of the reform, Pemex has fielded concerns from different international players in the oil-industry regarding the development of the new contractual forms, in particular regarding E&P in deep waters.

One such concern relates to surface extensions, required because of the nature of deep-water projects. The contracts will include very well-defined areas which will allow the corresponding company to exploit, develop and cause the relevant surface to reach an appropriate level of production. Larger areas better distribute inherent risks of these

projects and increase the chance of obtaining an appropriate return.

Contract duration is another issue. Since most projects involve a considerable investment along with a parallel risk upon the services' provider, the duration of the relevant agreements should take into account stable long-term relationships between the state and the relevant company which, in turn, would permit it to take advantage of its capital, know-how, people, experience, technologies and maximise the value of the corresponding surface, as well as recovering costs.

The oil industry's main concerns in connection with compensation are focused on how a company may recover the capital invested and the operative costs of these projects and how it may obtain a reasonable profit and incentives under the services regime contracts in force in Mexico.

Some of the most critical aspects with respect to the content of the contractual models relate to the incorporation of a "knock-for-knock" provision which would allow a service company to assess in advance what risks are inherent to a particular project, along with the potential losses which it may incur; in sum, the inclusion of a contractual provision whereby a company's liability may be limited up to the consideration which the latter is entitled to receive as per the relevant contract. The provisions would exclude consequential damages, the regulation of catastrophic damages, and the incorporation of arbitration clauses.

Amounts to be invested (figures in millions of dollars)	2009's investments	2009-2012's investments
PEMEX Exploration and Production	16,899	61,151
PEMEX Refining	1,920	13,116
PEMEX Gas and Basic Petrochemicals	353	1,609
PEMEX Petrochemical	208	2,929
Corporate matters	64	304
TOTAL	19,444	79,110

Planned investment by Pemex

New competition

Mexico's oil E&P market is already highly competitive amongst oil services providers such as Schlumberger, Halliburton and Weatherford. But oil operators such as Brazil's state oil company Petrobras and Repsol could compete with the above-mentioned oil services providers within Mexico's oil E&P market as the consolidated restrictions on sharing production contracts of last year's reform may cause and increase competition amongst oil services providers and oil operators. There are other important oil operators such as BP, Chevron, Statoil-Hydro and Shell that are expected to have a much more dynamic participation with the new E&P legal regime.

Considering the challenges posed by deep waters and other large projects, it seems that the leadership will be borne by one or more oil operators under consortium schemes where a large number of subcontractors for the provision of oil services will participate along with their chains of suppliers.

Taking into account the remarkable development of Brazil's energy sector, and the recent announcements made by the president of Mexico pursuing to achieve a strategic alliance between Pemex and Petrobras, it could be expected that Petrobras will play an increasingly important role in the Mexican market; in particular, with respect to deep and ultra-deep waters where Petrobras' expertise will become a prominent element to be considered. That said, other oil operators are fully capable and prepared to render comparable levels of expertise.

Pemex is facing an array of challenges. In E&P, the exploitation of mature fractured reservoirs will test Pemex's drilling capacity since it requires new forms of logistics that Pemex has never experienced before. Likewise, deep waters will require unprecedented investments and technological challenges. In refining, it is urgent to finish the upgrading of Mintitlán's refinery and of three other existing refineries, as well as to improve the environmental characteristics of the fuel which will require the construction or upgrading of 39 oil-refinery plants.

Pemex faces other infrastructure challenges with respect to pipelines that aren't technologically advanced - their average age being 24 years - and tankers that don't comply with international standards. Furthermore, loading and discharging operations are inefficient and there is a lack of infrastructure and multi-purpose capacity.

As previously suggested, Pemex will need new investments on deep-water technology and related offshore equipment, such as offshore skids and drilling rigs. It also requires better seismic data acquisition designs and improved quality and precision in its subsurface seismic images.

In other parts of its industry, Pemex will have to face diverse and urgent challenges to allow it to foster the development of technologies for specific recovery processes; improve hydro-treatment technology for the enhancement of Mexican heavy oil; enhance the carrying out of efficient drilling at lower costs; and more. Undoubtedly, such challenges will test its capability of overcoming its weaknesses.

As a result of the recent steps carried out by Mexico, Pemex has an unprecedented approved budget which allows it to pursue mid-term and long-term investment projects in all areas of the company.

Pemex E&P investment projects are focused on maintaining crude oil and gas production platforms and increasing the restitution rate of reserves as such projects represent 77 per cent of Pemex's total investments.

It is likely that with the new contractual regime and the autonomy of the board of directors, along with the challenges posed upon Pemex, clusters of oil contracts will be awarded to international oil company consortiums, which in turn will be able to subcontract related services

with other private companies. Undoubtedly, there are exciting times coming ahead for the national and the international oil industry.

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