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# Oil and Gas Law

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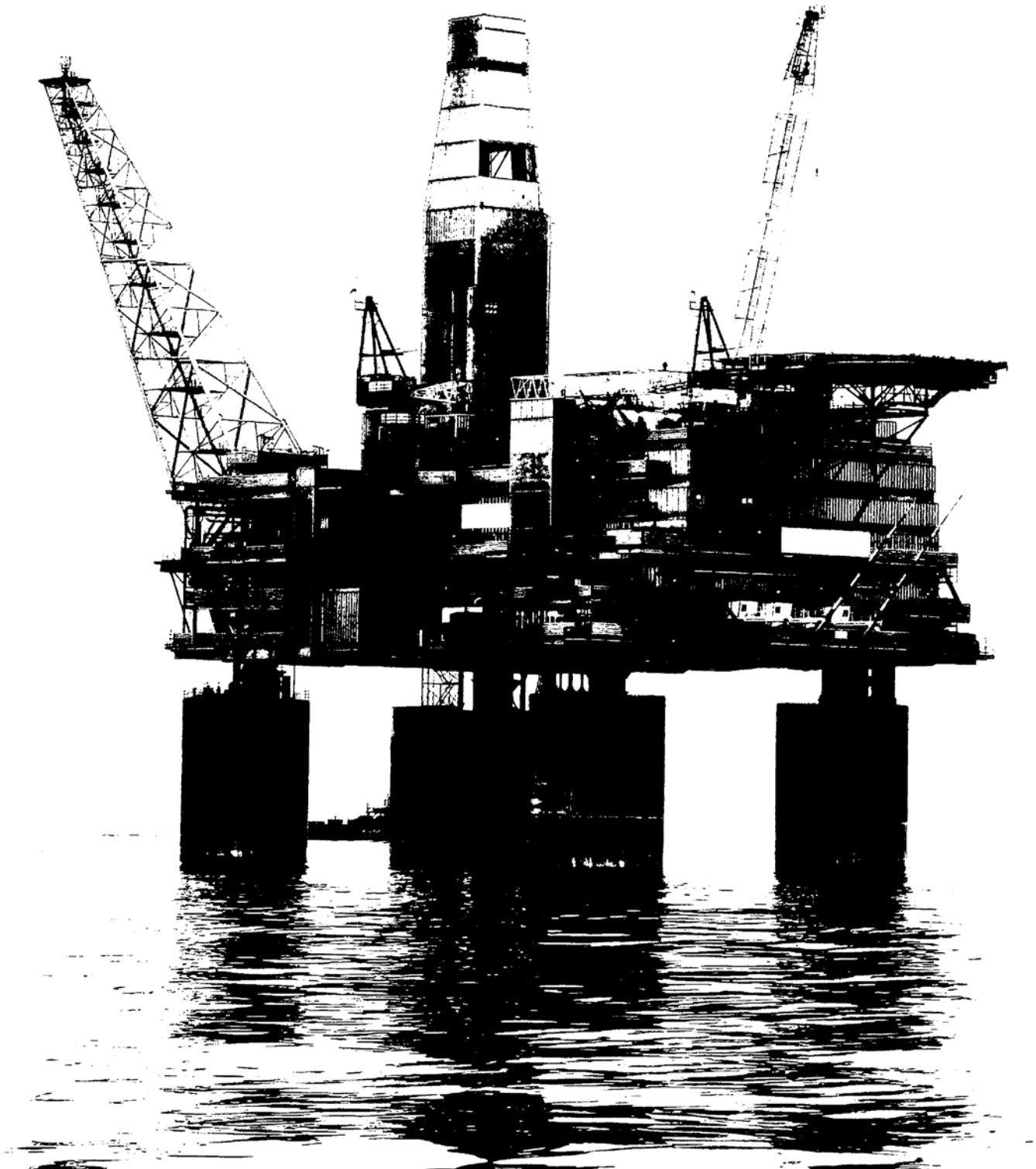

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## In this issue



## Articles



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the company's human resources department and with the company's business or operations group. This may seem like simply coordinating or liaising between groups, but the involvement should go beyond that. As counsel, one should make sure that the link exists between the needs of the business group or operations, the personnel provided by human resources, and the legal requirements of local content laws or regulations. Counsel should monitor a company's personnel structure to ensure compliance with the legal framework of local content requirements.

As counsel, one should not simply reiterate the laws to one's client(s), one must advise and help guide through the legal framework of local content requirements.

Local content requirements are not always easy to understand. Companies might have a difficult time finding sufficient competent, trained and educated personnel. Companies' costs might increase. Companies might encounter problems with corruption. Nonetheless, international companies need to be prepared for increasing local content requirements around the globe.

From country to country, the means of achieving the goal may differ, but the objective of local content requirements is the same.

# The new Mexican upstream legal regime: developing the E&P contracts

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### The main features of the 2008 legal reform: the new arrangements in context

28 November 2008 may be considered a date on which a major step for Mexico's upstream industry was accomplished. After more than 60 years of industry history, a set of reforms was enacted by the Federal Congress aiming to provide PEMEX with an exploration and production (E&P) legal regime closer to international best practices.

The package of reforms went beyond E&P, as it involved the suppression, amendment and enactment of numerous statutes in different matters such as: incorporating an upstream regulatory agency; fostering various sources of sustainable energy; developing public policy in terms of energy transition and its financing; and strengthening the role of the PEMEX's Board of Directors.

When originally submitted to Congress, the presidential bill went further beyond, aiming to liberalise the midstream and downstream markets. However, during the negotiations of the package, several politically-oriented tradeoffs took place, including those related to the said mid/down industries.

Although the 2008 energy reform is not as promising as the private sector expected, it should not be underestimated. Strengthening corporate governance, institutional design and best industry practices are intrinsically positive goals. The real acid test of the reform will be passed once the bid rounds regarding all relevant projects are successful and the performance of all players – including IOCs – results in a substantial increase of the national production.

### Understanding a complex NOC: PEMEX as a contractual operator versus a technical operator

When the likelihood of a potential upstream legal reform was originally discussed back in the spring of 2008, there were some constitutional taboos that were simply put aside of the congressional negotiations. Being absolute the state's ownership of hydrocarbons, alternatives that amounted to concessions, joint ventures or production sharing agreements were disregarded altogether.

Despite the restrictions, the team that took the lead on implementing the legal reform reviewed a cluster of jurisdictions (and their respective NOCs) with certain similarities to those of Mexico. Amongst them Iran, Kuwait, Saudi Arabia, Angola and – more recently – Iraq were considered as potential references in the context of an oil-service environment.

As a paramount aspect, the driver through the implementation path has clearly been the economic value creation, as opposed to political, ideological or even social motives that might influence the rather complex process.

When considering comparable markets as points of reference, the drafters – and their respective consultants – were fairly sensitive on balancing: the usage of internationally-based terms and technical standards; the simplification of the contractual structures, scopes and liabilities, as compared to the previous Mexican regime; and the need of creating an economic incentive for new players by means of developing a remuneration formula, that may be financially comparable to that of alternative schemes (ie, royalties or production sharing) but all times within the constitutional limits as per Mexican law.

As a result of the applicable upstream contracting rules, PEMEX has acknowledged that each new project requires a different incentive-based agreement and it has identified three different types of agreements, the use of which will depend, at all times, on PEMEX's needs and technological resources considering the complexities and interests of the corresponding project, as follows:

- conventional (services);
- transactional (acquisition of technology and, perhaps, contractor's know how); or
- integral (including all the project itself, that is from the engineering cost study to the execution of it). At least, integral incentive-based agreements or exploration, development and production (ED&P) are expected to be used, at least, in mature fields, *Chicontepec* and deep waters' projects.

In the light of the ED&P model, a bold line must be drawn to understand the role that PEMEX will have in the reinforced Mexican upstream industry:

*PEMEX as contractual operator*


PEMEX will award ED&P agreements related to vast reservoirs. The deliverable will be oil and gas, as opposed to mere service arrangements. The potential bidders will be either IOCs or robust consortiums of independent oil companies and/or multinational oil service companies. Along with other government agencies, PEMEX will mainly have a supervision role.

As announced by PEMEX, the projects that will be governed under this scope will be the strategic ones, including mature fields (both onshore and offshore); *Chicontepec* (once the field laboratories are finally assessed); and deep waters (the most challenging projects). Shallow waters projects may fall within the ED&P agreements once PEMEX decides on the basket to be designed based on its own technical capabilities to tackle these projects by itself.

*PEMEX as technical operator*


PEMEX will award service agreements in accordance with its current contractual practice; that is, to the best technical and economic proposal. As opposed to ED&P agreements, the deliverables will be services depending on the type of bid and the potential bidders will continue to be oil service companies, drilling corporations, rig operators, specialised shipping companies and other related upstream entities.

Although PEMEX will be assisted by the contractor, the main upstream activities will continue to be performed directly by PEMEX's personnel. The agreements to be covered under this second category are all those which are not included in the previous category.

Regardless of the operator hat to be worn by PEMEX depending on its role, the corporate governance, institutional design and relatively flexible remuneration formulas are applicable notwithstanding the specific

role of the NOC. Accordingly, even stand-alone services to be rendered to PEMEX will be substantially benefited by the new regime.

## ED&P modelling: PEMEX and the route towards crystallising the strategic projects

Some of the most relevant elements in the model to be equally used for Matured Fields as well as for *Chicontepec* (once the field laboratories show initial results) are the following:

- there will be a pilot phase of two to three years in which the field will be commercially assessed before development and production are initiated (voluntary relinquishment is permitted);
- although no time-limit is statutorily prescribed, the duration will be 20 years subject to unlimited extensions, depending on the characteristics of the field and the performance of the contractor;
- although the extension is also free to be determined by PEMEX, each block will be of over 75 square kilometres, that can be further amplified;
- practically all risks (including geological and operational) are on the side of the contractor;
- the deliverable is oil and gas production as opposed to services;
- the compensation structure (see Figure 3) covers: a fee per barrel; a 75 per cent reimbursement of the contractor's cost; and a compensation cap that will be determined according to the size of the field and the creation of economic value for PEMEX. Capital and operational cost will be fully paid during the pilot phase only;
- the bid will be directed to pre-qualified relevant companies;
- in any event, payment depends on the project's available cash flow;
- not even the booking of reserves for contractual purposes (as opposed to property booking) is allowed to the winning bidder;
- the financing of the project will be the sole obligation of the contractor (credit ratings will be required among the bid requirements);
- although restricted invitations and direct awarding may be decided by the PEMEX's Board, public bids will continue to be the general rule;
- among other relevant requirements, substantial operative experience of over 40 million b/d (aggregated figure) and over US$100 million of annual investment within the previous year;
- in addition to technological requirements, the winning bidder will be the one offering the largest fee discount for the service;
- all non-movable assets will be owned by PEMEX (ie, pipelines);
- contracts may be subject to arbitration abroad (ie, ICC rules).
- minimum work obligations and investments in both phases, even if there are reductions or extensions and the works will be carried out according to development plans to be approved by PEMEX;
- the performance indicator will include: productivity, budgetary efficiencies, safety and national content; and
- subcontracting operations to be authorised by PEMEX. Direction and management are not possible to subcontract.

Although there might be some significant differences, both deep waters projects and, if that is the case, large and medium shallow waters projects will include a great deal of the contents already in place for the other two upstream strategic projects. Naturally, BP's environmental situation in the Gulf of Mexico will certainly affect the contractual and regulatory contents of the strategic projects, especially those to take place in deep waters.