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Mexico's Round One: Bidding and Contract Terms for Shallow Water Areas

Mayer Brown LLP
Mexico Seminar

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I. BIDDING TERMS

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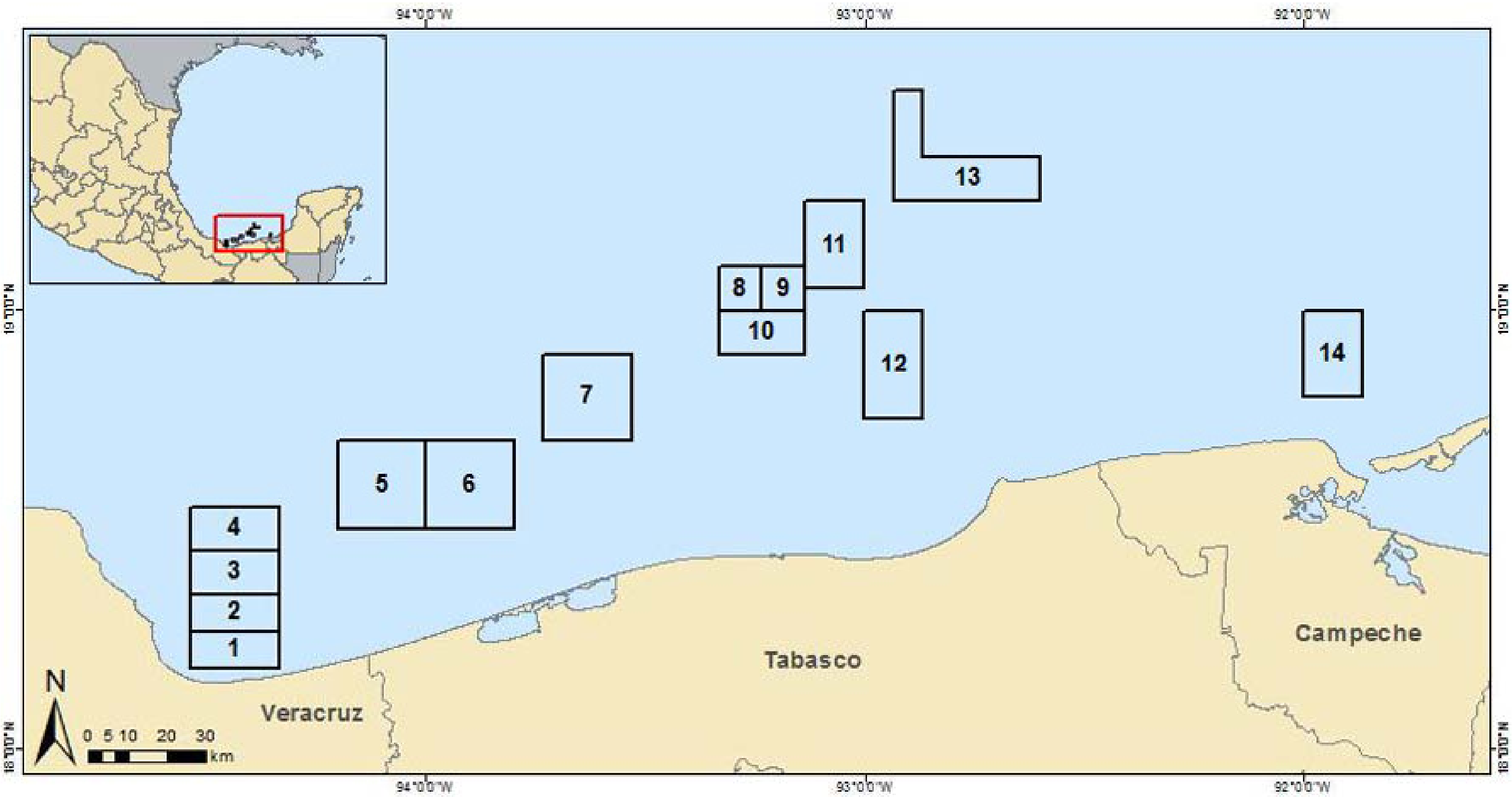
Round 1

- In August 2014, SENER announced Round One will include 169 blocks, comprised of 109 exploration blocks and 60 production blocks.
- SENER's updated tentative Round One timeline:

	Bidding Invitation	Data Room Access
Shallow waters (exploration)	Dec. 2014	Jan. 2015
Shallow waters (production)	Jan. 2015	Jan. 2015
Onshore	Feb. 2015	Mar. 2015
Chicontepec Basin and Unconventional	Mar. 2015	Apr. 2015
Deepwater	Apr. 2015	May 2015

First Phase:
14 Shallow Water Areas

- 14 contract areas in shallow waters, ranging in size from 116 sq. km. to 501 sq. km.



Source: SENER

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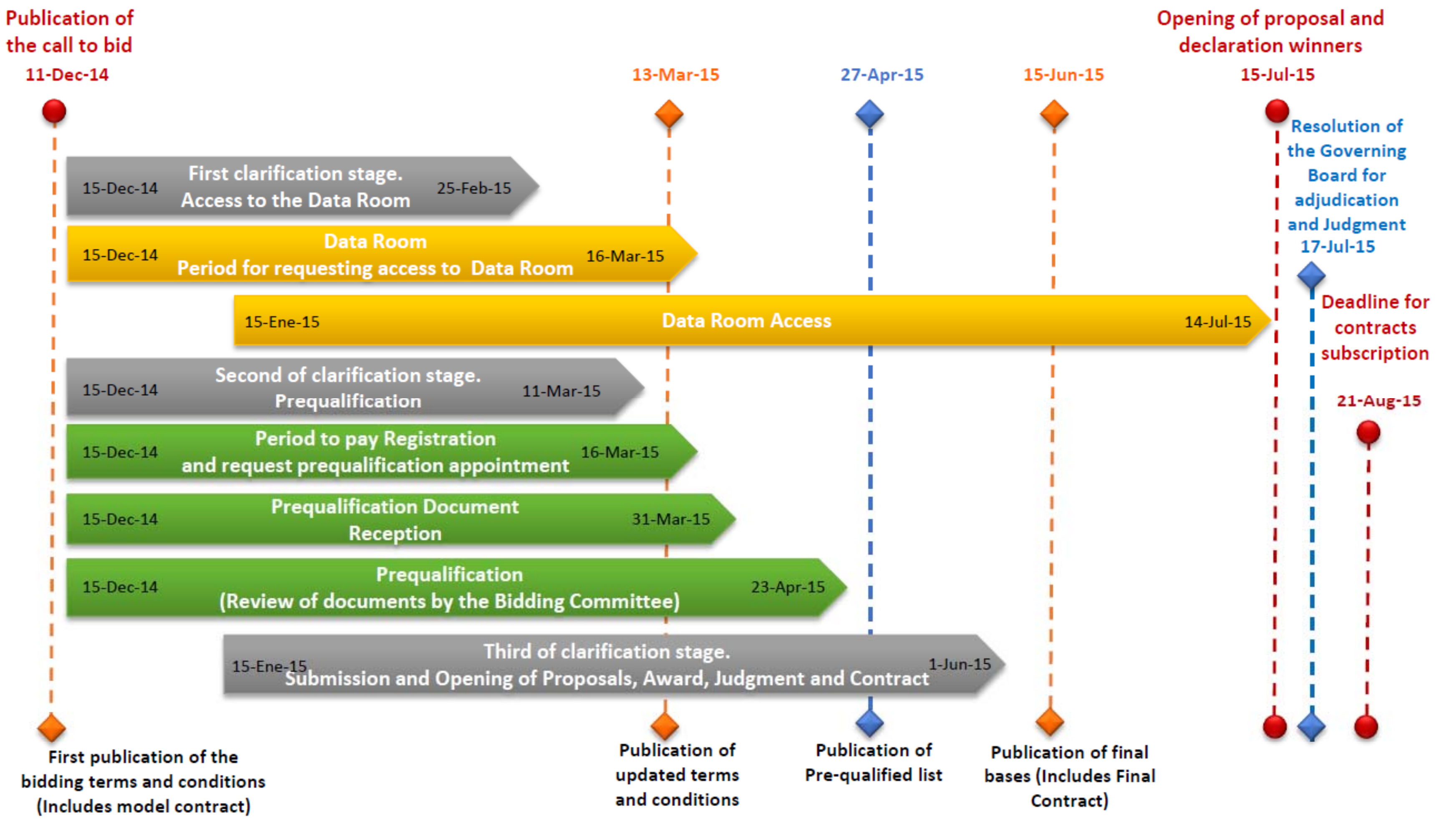
Dates and Deadlines



Source: CNH

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Requirements

- Any Mexican or foreign company may participate.
  - Either individually or in consortium.
  - No need to form a local entity to bid; just to sign the contract if awarded.
  - Consortiums must be registered by 31-Mar-15; subject to CNH's approval, financial partners can be added until 20-May-15, and other changes can be made until 10-Jun-15.
- No company may participate in more than one joint bidding group.
- A company cannot submit -individually or as a member of a consortium- more than one offer for the same contract area.
- Companies or consortiums may submit bids for no more than five contract areas.
- Large oil and gas companies with more than 1.6 MMBBLs per day of production cannot bid together (this might not apply for other areas).

Technical Requirements for Operators

- Demonstrate verifiable experience as operator during 2010 – 2014 in:
  - At least three exploration and production projects or
  - Exploration and production project(s) with aggregate capital investments of at least US$1 billion; and
- Demonstrate (1) experience as an operator in at least one offshore exploration and production project or (2) experience participating as a partner in at least two offshore exploration and production projects within the last five years; and
- Demonstrate that the proposed key personnel have at least 10 years of managerial and operational experience in offshore exploration and production projects; and
- Demonstrate experience in industrial safety and environmental protection during the past five years.

Financial Requirements for Operator

- Demonstrate a net worth of at least US$1 billion,
- Or, alternatively, demonstrate both:
  - Total assets of at least US$10 billion, and
  - An investment-grade credit rating of a major rating agency.
- Participants must demonstrate that the funds intended to be used for the bid are from a lawful source.

Financial Requirements for Consortiums

- If the operator does not qualify as per the prior test, the consortium must demonstrate a minimum aggregate net worth of US$1 billion.
  - Considering only the equity of no more than three consortium members.
  - Operator must demonstrate a minimum net worth of US$600.
- 1/3 minimum participating interest held by the operator.
- No consortium member can have a participating interest higher than the operator’s.

Fees and Bid Bond

- Fees:
  - Approx. US$350,000 for data room access (one per consortium).
  - Approx. US$18,600 for registration/participation.
- US$2.5 million standby letter of credit as bid bond.
  - To guarantee the execution of the contract and delivery of performance guarantee.
  - The bid bond by the winning bidder and the second bidder must remain valid for 60 days after submission.

Proposals and Contract Awarding

- Economic proposals per contract area must specify:
  - Share of operating profits offered to the State; and
  - Additional investment over the minimum investment commitment for each contract area.
- Sealed bids will be opened in a public event, transmitted via the internet.
- Winning bidder will be determined based on a weighted formula that factors in the State share of operating profits offered and an additional investment factor:
  - **V = 0.90 x State Share + 0.10 x Additional Investment Factor**
- Ministry of Finance to establish floor prices for State share and additional investment factor.
- Tie-breakers
  - Cash payment; and
  - Coin flip.

II. NATIONAL CONTENT AND PROCUREMENT RULES

National Content

- Constitutionally mandated minimum national content for E&P contracts.
- National content goals established by Hydrocarbons Law:
  - 25% by 2015; and
  - At least 35% by 2025.
- Deepwater and ultra deepwater activities subject to different thresholds to be determined.
- PSC model national content requirements:
  - During exploration period: 13%.
  - During production period: 25%, with annual increases resulting in at least 35% by 2025.

National Content Methodology

Goods	Labor	Services	Training	Technology transfer	Infrastructure

$$PCN = \frac{CNB + CNMO + CNS + CNC + TT + I}{B + MO + S + C + TT + I} \times 100$$

Percentage of local content

Mexican Local Content

25% — 35%

2015 — 2025

Exploration and Extraction of Hydrocarbons

Source: Mexican Ministry of Economy

National Content Methodology

Goods	Labor	Services	Training	Technology transfer	Infrastructure
Accumulated value of transformation made in Mexico along the entire supply chain	Payroll of National workers	National goods and labor used in services	Provided to national workers	Expenditures on the transfer of knowledge to improve the effectiveness and efficiency in the production of a good, the implementation of a process or the provision of a service	• Expenses incurred in Mexico to improve the urban and rural environment. • Investment in national territory.

Source: Mexican Ministry of Economy

National Content - Compliance

- National content compliance plan to be submitted for CNH approval as part of the contractor's development plan.
- Periodic national content reporting to the Ministry of Economy.
- The Ministry of Economy, with third-party support, will verify compliance of national content requirements for each E&P contract.
- PSC establishes liquidated damages for breach of minimum national content percentages.

Procurement Requirements

- Contractors must give preference to the procurement of national goods and the hiring of Mexican individuals for technical and managerial positions, in equal circumstances.
- Requirements for procurement of goods and services:
  - If < US$1,000,000 – no procurement process required.
  - If > US$1,000,000 – must obtain at least 10 bids, including at least 3 national companies.
  - If > US$20,000,000 – must conduct international public procurement process, treating all companies equally and selecting the best economic offer.
- Contractors must submit transfer pricing documentation for procurement with related parties.

III. PRODUCTION-SHARING CONTRACT TERMS

Contents

- On December 11, 2014, the Mexican National Hydrocarbons Commission (CNH) published the model production-sharing contract for the first phase of Mexico's Round One bid process relating to 14 form areas in shallow waters.

- CNH published one contract form for individual contractors and one form for consortia.

- This presentation summarizes the provisions of the model production-sharing contract for individual contractors as originally proposed. The SENER may introduce amendments in the course of the tender process.

Purpose

- The operations are to be performed at contractor’s sole cost and risk.
- Contractor may perform hydrocarbon exploration and production operations in the contract area on an exclusive basis.
- Title to hydrocarbons in place remains with the State, but contractors will be permitted to book reserves in accordance with applicable disclosure guidelines by securities regulators.

Duration

- 25 years from the effective date; extendable, at the request of contractor and subject to CNH approval, for two additional five-year periods.
- Contractor may voluntarily relinquish the contract area in part or in whole at any moment, terminating the contract with respect to the relinquished areas.
- Relinquishment shall not affect contractor’s obligations with respect to (i) completion of the minimum work program and (ii) abandonment.

Contract Phases

Exploration Period

- Initial exploration period of three years from the effective date, during which contractor is obligated to complete the minimum work program.
- The contracts for all contract areas will require seismic work. Additionally, two Contracts will require the drilling of at least one exploration well, and the remaining 12 Contacts will require the drilling of at least two exploration wells.
- Contractor may perform oil and gas operations in addition to the minimum work program.

Contract Phases (cont’d)

Exploration Period (cont’d)

- Initial exploration period may be extended with CNH approval for two additional one-year periods, provided Contactor commits to drill an additional well during each extension period with the same characteristics of the well(s) included in the minimum work program.

- Penalties for noncompliance with the minimum work program or the additional well commitments.

- Contractor must notify CNH in case of any discovery within five business days.

Contract Phases (cont’d)

Evaluation

- During any exploration period, contractor may request CNH approval for the evaluation of a discovery to determine if it can be considered a commercial discovery.
- Each evaluation period shall have a 12-month duration, which may be extended for an additional 12 months, subject to CNH approval.

Contract Phases (cont'd)

Declaration of Commerciality

- Within 60 days after the termination of any evaluation period, contractor must inform CNH if any discovery is commercial and, if so, within 90 days thereafter submit a development plan for CNH's approval.
- CNH may require modifications to any submitted development plan when CNH determines that, among others:
  - Gas flaring is excessive;
  - Reserves would be developed at excessive or insufficient rates;
  - There would be an excessive loss of pressure of the reservoir, or there would not be optimal separation between wells;

Contract Phases (cont'd)

<u>Declaration of Commerciality</u> (cont'd)

- The development plan is not consistent with best industry practices, including industrial security and health;
- The environmental risk assumed would not be acceptable under applicable law; and
- The program would create an adverse effect on the environment.

- Contractor must develop the commercial discovery pursuant to the approved development plan. Contractor may modify the development plan, subject to CNH's prior approval.

Contract Phases (cont'd)

Relinquishment Obligations

- Contractor shall relinquish and return 100% of the contract area that is not subject to a development plan approved by CNH or that has not been designated as an evaluation area.
- At the end of an evaluation period, contractor shall relinquish and return 100% of the evaluation area if contractor does not declare a commercial discovery or, having declared a commercial discovery, it fails to submit a development plan or fails to obtain CNH approval for such plan.
- At the end of all evaluation periods, contractor shall relinquish and return 100% of the evaluation areas not subject to a commercial discovery or, having a commercial discovery, is not subject to an approved development plan.

Contract Phases (cont'd)

<u>Production Operations</u>

- Beginning in the year in which the commencement of regular commercial production is expected, contractor shall include a production forecast for each well and for each reservoir in its work programs.
- Contractor must carry out all construction, installation, repair and reconditioning of the wells, gathering facilities and any other facilities necessary for the production operations, in accordance with the work programs approved by CNH and in compliance with the risk management program.

Unitization

- If a discovery is part of a structure, formation or deposit that extends beyond the contract area, contractor shall inform the SENER and CNH.
- Contractor will be subject to any unitization determination made by the SENER.

Annual Work Programs

- During the term of the contract contractor must submit annual work programs for CNH approval regarding each of the oil and gas operations contemplated under the contract.
- CNH will communicate to contractor any objection or observation regarding any annual work program, and contractor must modify the program accordingly before resubmitting it for CNH approval.
- CNH is obligated to approve the annual work programs if they comply with all of the following:
  - The minimum work program, exploration plan and development plan;
  - The accounting procedure and other contract terms;
  - Best industry practices and applicable law; and
  - The administration system related to security.

Annual Work Programs (cont'd)

- Contractor may modify an annual work program with the prior written approval of CNH.
- Before drilling a well, contractor must obtain drilling permits and authorizations.
- Contractor must also provide quarterly reports to CNH regarding the progress of the oil and gas operations conducted under the contract.
- Except as provided by law, once certain oil and gas operations have been approved by CNH within an annual work program, further CNH approval is not required for the design, engineering and construction of the facilities contemplated in the annual work program or the manner in which operations are conducted.

Budgets and Costs Eligible for Recovery

- Contractor must also submit for CNH approval a budget for each annual work program.
- Any modifications to the budget require prior CNH approval.
- Costs incurred in relation to the oil and gas operations under the contract will be considered as eligible for recovery only if they are strictly indispensable and meet the requirements established by the contract and the applicable rules issued by the Finance Ministry.

Budgets and Costs Eligible for Recovery (cont'd)

- An extensive list of costs that are not recoverable is established in Section 2.3 of Annex 4 of the contract, which includes, among others:

  (i) The costs, expenses or investments that are unrelated to the contract and those incurred before the effective date of the contract or after its termination;

  (ii) The costs, expenses or investments that don't have supporting documentation, those that have not been registered in the operating account, or those that have not been included in the budgets and work programs approved by CNH;

Budgets and Costs Eligible for Recovery (cont'd)

(iii) The costs, expenses or investments that elevate the total budget over 5% of the original budgeted amount or 10% over the original budgeted amount for a specific item;

(iv) Financial costs;

(v) Costs of rights-of-way, easements, temporary or permanent occupations, leasing, land acquisition, indemnifications and any other similar rights; and

(vi) Legal and consulting fees, except for those related to geological studies for the exploration and extraction of hydrocarbons that have been approved in the work programs and their respective budgets.

Budgets and Costs Eligible for Recovery (cont'd)

- All procurement of goods and services related to the oil and gas operations shall be subject to the principles of transparency, economy and efficiency.
- Up to 60% of the value of production in any month may be allocated to cost recovery. Any unrecovered costs will be carried forward until fully recovered.

Metering Points and Receipt of Net Hydrocarbons

- The volume and quality of the hydrocarbons produced must be measured at a metering point "within the contract area."
- CNH may request metering at the wellhead.
- The measuring standards must be pursuant to the Manual of Petroleum Measurement Standards of the American Petroleum Institute, best industry practices and applicable law.
- The installation, operation, maintenance and calibration of the metering system will be the responsibility of contractor under CNH's supervision.

Equipment and Facilities

- During the term of the contract, contractor will maintain title to all materials, equipment, pipes, drilling or production platforms, infrastructure, and facilities generated or purchased for the operations under the contract and charged to the operating account.
- Title to such property will pass to the State, at no charge, upon termination of the contract for any reason.
- Contractor may not use the materials, equipment and facilities for purposes different than the oil and gas operations related to the contract.
- Leased assets and purchase options.

Permits

- Contractor is responsible for obtaining all governmental permits required under applicable law to conduct the oil and gas operations under the contract.

Additional contractor Obligations

- Contractor must conduct the oil and gas operations continuously and efficiently pursuant to CNH-approved exploration and development plans, work programs, best industry practices, the contract, the administration system for security and applicable law.
- Contractor must provide all the personnel and the technical, financial and other resources necessary to carry out the oil and gas operations.
- Contractor is responsible for providing all materials, equipment and facilities required to carry out the oil and gas operations.
- Contractor is obliged to provide CNH with all the seismic, geological and geophysical information, data and interpretation related to the oil and gas operations under the contract.

Production Handling and Ownership of Production

- Contractor may use produced hydrocarbons for oil and gas operations as fuel or for injection or lifting, free of royalty charge or profit accounting, up to the levels approved by CNH in the development plan.
- Contractor may not burn or flare natural gas except within the limits authorized by the environmental agency or as necessary to prevent an emergency, subject to applicable law.
- The production is owned by the State until the Metering Point. At the metering point, the contractor shall own its share of production (cost recovery plus share of profits) and may market its share of production for its own account.
- Contractor shall deliver to CNH's marketing agent the share of production that belongs to the State (royalties and the State's share of profits). The Mexican Oil Fund will receive the proceeds from the sale of such production.

Payments and Split of Production

- The Mexican Oil Fund will determine the production allocations each month. The Fund is in charge of administrating the financial aspects of the contract and responsible for the calculation of the production entitlements.
- The Fund will issue a certificate of payment-in-kind accrediting the volume of hydrocarbons that contractor has a right to under the terms of the contract.

Payments and Split of Production (cont'd)

State's Share:

- The volume of hydrocarbons that corresponds to the royalties (as determined for each type of hydrocarbon through the application of a royalty rate established in the contract, applied to the "Contract Value" of the oil, natural gas and condensates produced in the month).
- The volume of hydrocarbons that corresponds to the State's share of operating profits. The initial percentage share of State profits will be that which was offerred by the contractor in its bid. This percentage will then be adjusted upwards as a function of certain defined IRR thresholds achieved by the contractor under the Contract.
- The total operating profits will be determined monthly by subtracting the value of recoverable costs and royalties from the Contract Value of production.

Payments and Split of Production (cont’d)

<u>Contractor’s Share</u>:

- The volume of hydrocarbons allocated to the recovery of eligible costs (subject to the monthly cap of 60%); and
- The volume of hydrocarbons that corresponds to the remaining share of operating profits after payment of the State’s share of operating profits.

Payments and Split of Production (cont'd)

Contract Value of Hydrocarbons

- The volume allocations between the State and the contractor will be calculated and made monthly considering the Contract Value of the hydrocarbons produced.
- The value for oil and condensates will be first determined by reference to crude oil price benchmarks and the volume allocations will be made on that basis. In the month following the month in which the production is actually sold, the volume allocations will be adjusted by reference to actual sales prices under market terms and conditions.

Payments and Split of Production (cont'd)

- In the case of natural gas, the value shall be defined initially by the price set by the CRE at the point at which the natural gas produced under the contract enters the integrated national transportation and storage systems. Upon the actual sale of the gas, the value will be adjusted to the greater between the price determined by the CRE and the agreed sale price between contractor and its buyer.
- The value of production shall be calculated net of processing, storage and transportation costs that contractor incurs after the metering point and until the produced hydrocarbons are sold.

Payments and Split of Production (cont'd)

- A cash payment by the contractor to the Fund of the exploratory phase contract fee, which will apply to the contract area not included within a development plan approved by CNH. The fee will be 1,150 Mexican Pesos per square kilometer during the first 60 months of the contract and 2,750 Mexican Pesos per square kilometer starting from month 61 of the contract. The value of the monthly fees will be adjusted annually according to the National Consumer Price Index of the previous year, published by the National Institute of Statistics and Geography.

Performance Guarantees

- Performance guarantees for the minimum work obligations in the initial exploration period, first additional exploration period and second additional exploration period.
- Corporate guarantee for the performance of all of contractor’s obligations under the contract, including all payments to CNH and the Fund.
  - Granted by the ultimate parent of contractor or, in the case of a consortium or association, the ultimate parent of each of its members.

Abandonment

- The development plan, as well as each work program and budget submitted for CNH approval, must contain provisions related to the abandonment of the contract area.
- If contractor makes a commercial discovery, contractor shall set up an investment trust, under joint control of CNH and contractor, as a reserve to fund abandonment operations in the contract area.
- It is the responsibility of contractor to carry out the abandonment work, regardless of whether or not there are sufficient funds in the investment trust.

Administrative Termination

- CNH may declare administrative termination of the contract in any of the following events:
  - 180 consecutive days pass without contractor initiating the operations included in the exploration plan or development plan or contractor suspends operations for that same period, without any CNH authorization or justified cause;
  - Contractor does not comply with the minimum work program, without justified cause;
  - Contractor partially or completely assigns the operations or its interest under the contract without CNH approval;

Administrative Termination (cont'd)

- A serious accident occurs because of the willful misconduct (*dolo*) or fault of contractor that causes damage to facilities, death or loss of production;
- Contractor, on more than one occasion, delivers false information willfully or unjustifiably or omits certain information from government authorities regarding production, costs or any other relevant aspect of the contract;
- Contractor does not comply with a final resolution of federal jurisdictional bodies; or
- Contractor omits, without justified cause, any payment to the Mexican State or delivery of hydrocarbons pursuant to the terms of the contract.

• CNH must give contractor at least 30 days, advanced notice. CNH may terminate the contract with immediate effects and without the need of a judicial resolution if the contractor does not cure the event of default within such term.

Contract Termination

- CNH may also terminate the contract for any of following events:
  - Contractor does not deliver the exploration plan or the work program of the first exploration period to CNH within 45 days of their due dates;
  - Contractor has a 180-day delay in the performance of any work program or development plan submitted;
  - Contractor does not deliver the performance guarantees for the exploration period or the corporate guarantee or does not maintain them in effect;
  - Contractor withholds relevant information or delivers false information to authorities with respect to the production, costs or any other issue related to the oil and gas operations;

Contract Termination (cont'd)

- Contractor or the guarantor is liquidated or ceases to legally exist;
- Contractor enters insolvency or is unable to pay its debts;
- Any of contractor's representations and warranties pursuant to the contract, or those made during the bidding round, is demonstrated to be false as of the effective date;
- Contractor violates the contract assignment rules or has a change in control without CNH consent;
- Contractor violates the anticorruption and conflict of interest provisions of the contract; or
- Any other material noncompliance of contractor with its obligations under the contract.

Effects of Termination

- If CNH declares administrative or contractual termination of the contract, contractor:
  - Shall pay the State, through the Mexico Oil Fund, monetary penalties established in the contract in the case of breach of the minimum work obligations or direct damages incurred by the State (excluding any indirect, consequential, loss of profit and business opportunity);
  - Shall cease all operations in the contract area (except those necessary to preserve and protect materials and equipment) and shall return the contract area to CNH as early as possible;
  - Does not have any compensation rights upon the termination of the contract; and
  - Must comply with all of its obligations regarding the return of the contract area, including abandonment obligations.

Assignment and Change of Control

- Prior CNH consent is required.

Indemnity

- Contractor is required to indemnify and protect CNH and any other governmental authority against any actions, claims, damages, costs, taxes, expenses and losses for noncompliance of the contract and damages caused by contractor or its subcontractors.

Dispute Resolution

- Mexican law shall apply.
- Mediation is mandated as a first step for up to three months before arbitration can be initiated.
- Mexican federal courts shall resolve any issues related to the administrative termination of the contract.
- Arbitration
  - Rules: UNCINTRAL
  - Number of arbitrators: 3
  - Language: Spanish
  - Place: The Hague, Netherlands

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