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Oil and Gas Tenders in Mexico Proceed With Additional Specificity in Draft PSC

Editor's Note: This is one in a continuing series of Q&As with Locke Lord lawyers on key legal issues confronting companies engaged in industries that have national and global impact.

Where does Mexico's upstream oil and gas bid round process stand?

SJA: The tender for the first package of properties auctioned as part of Mexico's "Round 1" covered shallow water blocks and ended on July 15, 2015, with much fewer awards than anticipated — only 2 of the 14 blocks tendered. Bids are now due on September 30, 2015 for 5 shallow water areas that form the second package put out for bid under Round 1. The bid solicitation for the third package (which will consist of onshore properties) under Round 1 is scheduled to end on December 15, 2015. The Mexican Comisión Nacional de Hidrocarburos ("CNH") currently plans to auction two other packages as part of Round 1 — one deep water and extra heavy oil package and one package of unconventional properties. Although the CNH has yet to set the schedule for the last two tenders, it has stated that the call for bids for the deep water package will be launched by the end of September 2015 and announced that the tender for the unconventional properties has been suspended.

Given the outcome of the first phase of Round 1, has the Mexican government taken noticeable steps to improve results in future tenders?

SJA: The Mexican government is fully aware of the concerns raised by bidders in the first tender — as well as those who chose not to bid. In response to such concerns, the CNH released several rule changes in August 2015 designed to make the second tender more attractive. The changes include lowering the required shareholder equity value for a corporate guarantor (from \$6 billion to \$2 billion), allowing bidders to apply a \$2.5 million guarantee to all blocks on which they bid and not just one block, giving the bidders a larger slice of earnings, and allowing upstream drillers to keep assets that they would have had to forfeit under prior rules if the PSC were revoked for willful misconduct. In addition, the regulators added specificity to the PSC provision governing administrative rescission (Section 22.1) in an attempt to give private investors more confidence that this right will not be invoked arbitrarily. The rule changes also give bidders acting as consortia in the second phase increased flexibility to restructure their consortia up to one week away from the bidding deadline.

Following the changes discussed above, what remaining issues are viewed as substantial challenges to private oil and gas companies in the Round 1?

SJA: It is impossible to know with certainty how bidders have reacted to the August changes until second phase bids are opened on September 30, but industry observers generally view those changes favorably. Despite such improvements, potential bidders — particularly those outside of Mexico — still have important concerns. On a contractual level, one of the provisions that has caused the most concern is Section 22.1 of the draft PSC, which allows for administrative rescission by CNH if certain events occur. Although some of the enumerated events are fairly common in international contracts of this kind, they include others that are not, including the submission more than once of false or incomplete reports to CNH and other Mexican authorities and the occurrence of a serious accident that causes damage to the facilities, loss of life and loss of production. The changes to the draft PSC issued in August add specificity to Section 22.1 designed to give bidders comfort that administrative rescission can or will only be used in narrow circumstances, but Section 25.4 of the PSC continues to require that any disputes concerning administrative rescission be decided by the Federal Courts of Mexico (unlike other disputes, for which the contract allows arbitration). Unfortunately, both provisions are requirements of the Mexican Hydrocarbons Law, so they cannot be modified without a change in law. Although the Mexican courts have definitely ruled against the government in the past, some potential bidders continue to look with suspicion at this requirement that one Mexican governmental entity (the Federal Courts) must determine the propriety of an administrative rescission exercised by another Mexican governmental entity (CNH). Despite the validity of such contractual and legal concerns, industry players frequently choose to manage similar risks if the geological and economic prospects offered are sufficient, and both were questioned by many in the first phase. Whether the market will determine that the geological and economic opportunities offered in the second phase or beyond are sufficient in a continuing low price environment that is causing even majors to reject investment options in jurisdictions with arguably lower political risk remains to be seen — and that environment threatens to be even more worrisome as tender redeterminations come up in October.

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