www.ogel.org

ISSN : 1875-418X
Issue : Vol. 14 - issue 1
Published : March 2016

This paper is part of the OGEL Special on "*Mexico's Oil and Gas Sector Reform*" edited by:

Professor Owen L. Anderson

Professor and Distinguished Oil & Gas Scholar, Kay Bailey Hutchison Center for Energy Law and Business, The University of Texas School of Law and McCombs School of Business.
Professor Anderson is also the Kuntz Chair Emeritus and Cross Research Professor Emeritus at The University of Oklahoma College of Law.

Oil, Gas & Energy Law Intelligence

The Mexican Licensing Regime for Hydrocarbons: Lessons from other Jurisdictions - The United Kingdom?
by D. Huth

About OGEL

OGEL (Oil, Gas & Energy Law Intelligence): Focusing on recent developments in the area of oil-gas-energy law, regulation, treaties, judicial and arbitral cases, voluntary guidelines, tax and contracting, including the oil-gas-energy geopolitics.

For full Terms & Conditions and subscription rates, please visit our website at www.ogel.org.

Open to all to read and to contribute

OGEL has become the hub of a global professional and academic network. Therefore we invite all those with an interest in oil-gas-energy law and regulation to contribute. We are looking mainly for short comments on recent developments of broad interest. We would like where possible for such comments to be backed-up by provision of in-depth notes and articles (which we will be published in our 'knowledge bank') and primary legal and regulatory materials.

Please contact us at info@ogel.org if you would like to participate in this global network: we are ready to publish relevant and quality contributions with name, photo, and brief biographical description - but we will also accept anonymous ones where there is a good reason. We do not expect contributors to produce long academic articles (though we publish a select number of academic studies either as an advance version or an OGEL-focused republication), but rather concise comments from the author's professional 'workshop'.

OGEL is linked to **OGELFORUM**, a place for discussion, sharing of insights and intelligence, of relevant issues related in a significant way to oil, gas and energy issues: Policy, legislation, contracting, security strategy, climate change related to energy.

The Mexican Licensing Regime for Hydrocarbons: Lessons from other Jurisdictions - The United Kingdom?

Daniel Huth, LL.M. (Aberdeen)[1]

"We were below the expectation"[2], as Juan Carlos Zepeda, commissioner of Mexico's National Hydrocarbons Commission ("Comisión Nacional de Hidrocarburos" – CNH), stated once the results of the first bids in *Ronda Uno* were public. In a first attempt of explaining the results he continued that *"(…) oil prices in the short term are not all of the answer"* but that there were "*other considerations we need to be looking at."*[3] These quotations comprise two of the main avenues of explanations for the mixed results of the first bids: the current low oil price as well as unknown and almost "mysterious" other factors inherent to the framework in place at the moment. Three bids with mixed success later, and with four Model Contracts in place, it will be of particular interest to focus on the latter, as the success of the terrestrial bids has partly refuted the oil price argument. As it was for the Mexican authorities that established the current legal framework in the first place, it might also be helpful to look for solutions outside the scope of the current framework and draw comparisons to other jurisdictions.

A brief summary of the above could be the following: Mexico has problems attracting investors to explore and produce hydrocarbons on Mexican territory.

Current situation of low oil prices to blame?

It is not far-fetched to blame the current oil price for the lack of interest to invest in Mexican hydrocarbons: Chevron Corp., Exxon Mobil, Shell, to name just a few, all suffered significant losses of profit[4] and their stock market value since the slump of the oil price begun. Shell recently announced cuts amongst its employees. These examples are no exception. They simply reflect the current market situation, and it is not surprising in this situation that new investments are made with caution, if at all. Apart from the first round bids on shallow water blocks, Mexico has tried to adjust to these new market realities by modifying its bidding criteria and rules—e.g., for the recent and rather successful terrestrial bids, which usually are technically and financially not that challenging, but Mexico will need to take great care in designing bid criteria and rules for its deep and ultra-deep water blocks, where operations are usually even more capital intensive. The current market situation is bound to influence investors' decision to participate and bid in upcoming phases of the round.

However, the market situation is not necessarily the only explanation. CNH must become more sensitive to the market, as CNH cannot change it. And it is unlikely that the oil market will change anytime soon. Indeed, oil prices have further declined since the first phase of

---

[1] Foreign Associate at Von Wobeser y Sierra S.C. Mexico City, engaged in the practice areas International Arbitration, Energy & Resources and Oil and Gas. Author gratefully acknowledges comments and input by Lic. Edmond Grieger, LL.M. Partner and head of the Environment, Energy & Natural Resources practice at Von Wobeser y Sierra S.C.

[2] http://www.oilandgasinvestor.com/round-one-mexico-disappoints-810076.

[3] Ibid.

[4] http://www.woodmac.com/media-centre/12529876.

Round 1 was conducted. According to the World Bank Commodities Market Outlook 2015,[5] Iran re-entering the market following the Iranian Nuclear Deal might even reduce average crude prices by an additional US$ 10 per barrel. Therefore solutions have to be found detached from and yet sensitive to the market situation, which is and will remain volatile. Mexico's petroleum challenge goes beyond oil prices. In this article I will focus on the current model contracts forming the legal framework surrounding the bids, which lie entirely in the powerful hands of the CNH, and are therefore a suitable "playing field" for potential amendments.

The current legal framework surrounding the bids

It is beyond the scope of this article to provide an analysis of the constitutional amendments of the Energy Reform, which are at the root of permitting foreign investments in Mexican oil and gas operations. For the purpose of this article, it is sufficient to analyse the law of implementation of the constitutional amendments.

According to "Transitorio Cuarto" of the Mexican Constitution, Mexico may offer any of several types of agreements to petroleum investors: 1) service contracts, 2) profit sharing contracts, 3) production sharing contracts, 4) license agreements and 5) a combination of the above.[6] It is beyond the scope of this article to provide an analysis of all these options. At this moment, the government has offered only production sharing agreements ("PSA") for shallow water and licenses for onshore and deep water.

Comparing the most significant terms of the model PSA´s[7] for the first two bids and the model licensing agreements for the third and fourth bids[8], it becomes clear that both types of investment opportunities share similarities. The contract term in the cases of the first three bids is ranging between 25 and 30 years with the possibility of two 5-year extensions (for the deep and ultra-deep water the contract term is 35 years and provides for an optional extension of up to 50 years). Both types of opportunities require a minimum work program. Both contain local content provisions and require the contractor to provide significant financial guarantees.

All "model agreements" provide for arbitration as the method of dispute resolution with the exception of certain of administrative decisions, including rescissions, which are to be resolved by Mexican federal courts. This is a noteworthy exception to arbitration considering that contracts entered into with sovereign states lead to the necessity of escaping "the

[5] See http://siteresources.worldbank.org/INTPROSPECTS/Resources/334934-1304428586133/GEP2015c_commodity_Jul2015.pdf at page 3.
[6] "La ley establecerá las modalidades de las contraprestaciones que pagará el Estado a sus empresas productivas o a los particulares por virtud de las actividades de exploración y extracción del petróleo y de los demás hidrocarburos que hagan por cuenta de la Nación. Entre otras modalidades de contraprestaciones, deberán regularse las siguientes: I) en efectivo, para los contratos de servicios; II) con un porcentaje de la utilidad, para los contratos de utilidad compartida; III) con un porcentaje de la producción obtenida, para los contratos de producción compartida; IV) con la transmisión onerosa de los hidrocarburos una vez que hayan sido extraídos del subsuelo, para los contratos de licencia, o V) cualquier combinación de las anteriores." see http://www.diputados.gob.mx/LeyesBiblio/htm/1.htm.
[7] http://ronda1.gob.mx/wp-content/uploads/2015/12/R01L01_Individual-contract_20150609.pdf and http://ronda1.gob.mx/wp-content/uploads/2015/12/R01L02-Individual-contract_20150825.pdf.
[8] http://ronda1.gob.mx/wp-content/uploads/2015/09/R01L03-Individual-contract_20151120.pdf and http://ronda1.gob.mx/wp-content/uploads/2016/01/R01L04-Licence-Deep-Water-Individual-Clean-V2.pdf.

normative or prescriptive power of the State"[9]. Consequently, "nearly all Production Sharing contracts contain an arbitration clause".[10] This imbalanced situation makes it essential not to rely on the host states jurisdictional power, but to refer any disputes arising from the PSA or license to international arbitration as a first step.[11] However, in Mexico, government action to administratively rescind a PSA or license is solely reviewable by Mexican courts—as part of a more broad exception to arbitration within the PSA-Model and as part of a more narrow exception in the licensing regime. Even in the latter case, where the exception applies only to the administrative termination of the contract, it provides for a considerable amount of insecurity, as according to Art. 22.1(b) of the model PSA the CNH may declare administrative rescission of the contract in the event that "[t]he Contractor fails to comply with the Minimum Work Program *without just cause*" (emphasis added). The decisive question whether the cause is justifiable is a question an investor typically would like to see resolved by an institution independent from the host state. Considering the duration of the agreements, the likelihood of disputes is significant. Arguably, this can be considered as one of the legal reasons why investors were reluctant to place bids.

Although there are further discrepancies between PSAs and licenses, they are applied in a similar manner, and both still need to provide an attractive legal framework to investors. Consequently, despite the mentioned discrepancies, the search for solutions to the current issues within both types of agreements can be conducted simultaneously.

For many years, both PSAs and licenses have been used in jurisdictions across the globe to regulate the exploration and production of hydrocarbons. Thus, Mexico can learn from the experience of other nations. Whereas the "PSA-Model" can be found in most oil producing African and several Asian states, a licensing regime is widely applied in developed states such as Australia, Netherlands, Norway the United Kingdom (UK), and in a number of countries in Latin and South America. The UK could be of particular interest as a role model for the Mexican licensing regime, as it not only has decades of experience in successfully applying a licensing regime, it has a mature producing continental shelf, which has challenged the government to find ways to promote continued IOC investment. These basic similarities beg two questions:

- What problems relevant to the Mexico situation have arisen in promoting investment in the UKCS?
- Are the UK's government's solutions transferable to Mexico?

Amendments during the drafting procedure

Since the bidding on blocks has commenced in July 2015, the CNH has not remained inactive with regards to changing the Model Contracts. It is beyond the scope of this article to present and evaluate all amendments that have been done. Nevertheless, a few selected changes are presented to demonstrate the type of improvements that have been achieved so far.

[9] Bertrand Montembault, 'The stabilisation of state contracts using the example of oil contracts. A return of the Gods of Olympia?' (2003) 6 International Business Law Journal 593, 602.
[10] Klaus Peter Berger, 'Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators' (2003) 36 Vanderbilt Journal Of Transnational Law 1347, 1370.
[11] A. F. M. Maniruzzaman, 'Some Reflections on Stabilisation Techniques in International Petroleum, Gas and Mineral Agreements' (2005) 4 International Energy Law and Taxation Review 96, 100.

Considering the PSA applicable to the second bids of September 2015, the amendments to the financial guarantees set forth in clause 16 are of interest. Effective August 4, 2015 the guarantees have been amended to be more investor friendly for the bids on shallow water blocks. According to Article 16 (1)(b) and 16 (2)(a)-(c) and Annex 6[12], with the CNH´s permission, the financial guarantees can be reduced from formerly 6 billion US$ to the equivalent of 18 times the combined value of the Minimum Work Program and the increment value in the Minimum Program.

With regards to the third bids of December 2015, the licensing agreement has been amended regarding securities and warranties that have to be provided by contractors. According to Article 16.1[13] the contractor may opt for the presentation of a letter of credit or a bond policy as the warranty to ensure compliance with the commitments during the evaluation period. Moreover, the corporate warranty for Type 2 blocks has been set at US$ 300m (see Art 16.2 (b)(1)) and at US$ 7.5m for Type 1 blocks (see Art 16.2 (b)(2)). In addition, simultaneous multiple bids can be made without the necessity to provide minimum financial capabilities (depending on the type of block, varying between US$ 5m (Type 1) and US$ 200m (Type 2)) for each bid or for the hypothetical scenario of success in all of the placed bids. In the case of limited capacities, the successful bids were valid only up to the maximum of matching financial capabilities.

Also the arbitration clauses have been revised. From the second bid onwards the contracts set forth that investors may "initiate proceedings before an arbitration tribunal" in cases of administrative rescission "only for the determination of the existence of damages, and in such case, their quantification, that result in a cause or causes of administrative rescission considered as unfounded by the Federal Courts in a definite manner."[14]

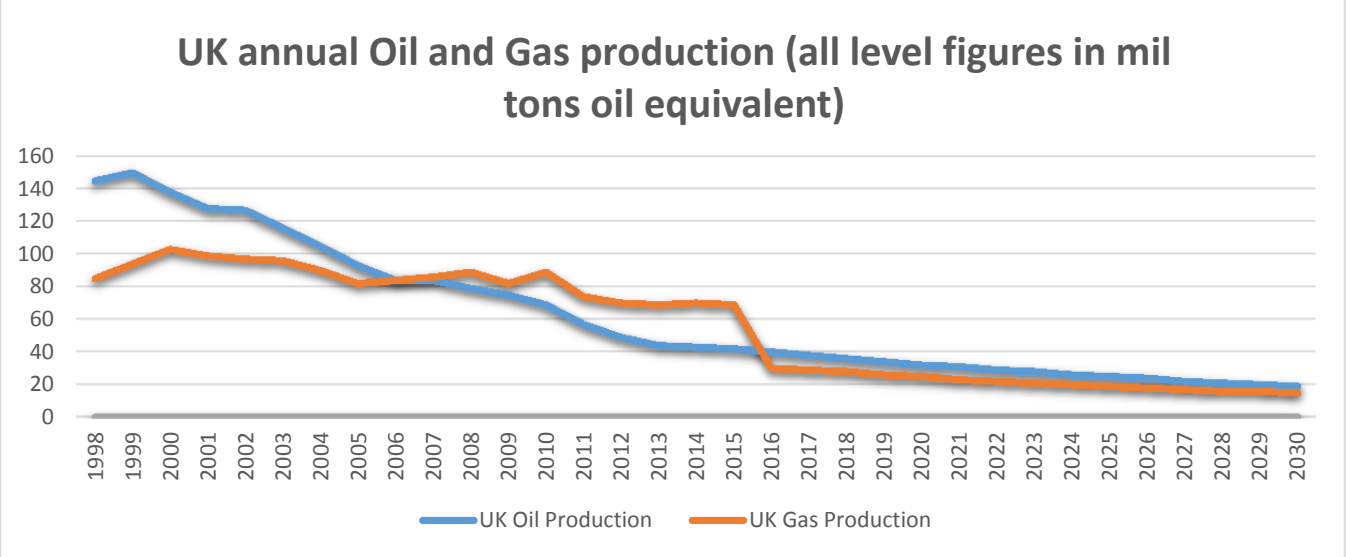
A further point to note are the amended national content provisions presented in the first draft of the Model License Contract applicable to the 4th bids on deep and ultra-deep water blocks in 2016.[15] While the percentages in previous bids were ranging between 13% and 38%, they are now narrowed down to 3% to 10%. Arguably, this can be interpreted as the reaction to the particularities of deep and ultra-deep water operations, coupled with the fact that Mexico is short on deep-water and ultra-deep water experience and equipment.

Current problems occurring in the UKCS

As reported in the so called "Wood Review"[16], the following graph[17] illustrates the main issues that have arisen in the maturing UKCS. Since the peak in 1999, where within the

[12] This applies to both contracts for individuals and consortiums, http://ronda1.gob.mx/wp-content/uploads/2015/12/R01L02-Consortium-contract_20150825.pdf and http://ronda1.gob.mx/wp-content/uploads/2015/12/R01L02-Individual-contract_20150825.pdf.
[13] http://ronda1.gob.mx/wp-content/uploads/2015/09/R01L03-Individual-contract_20151120.pdf .
[14] See for example clause 26.4 of the model licensing contract for the 4th bids on deep and ultra-deep water blocks in 2016 http://ronda1.gob.mx/wp-content/uploads/2016/01/R01L04-Licence-Deep-Water-Individual-Clean-V2.pdf.
[15] http://ronda1.gob.mx/wp-content/uploads/2015/12/Licencia-AP-Individual-publicado.pdf.
[16] UKCS Maximising Recovery Review: Final Report, 24th February 2014 available at http://www.woodreview.co.uk/documents/UKCS%20Maximising%20Recovery%20Review%20FINAL%2072pp%20locked.pdf.

UKCS almost 150 million tons of oil equivalent had been produced, productions since then has dropped to around 43 million tonnes in 2014. Nonetheless, optimists forecast production to pick up and increase by approximately 14% between 2013 and 2018.[18]



The situation in the UKCS is further complicated by the reasons behind the decreasing production: Decreasing recovery in existing fields led to decreasing exploration activities, as investments became economically less attractive (an effect currently being leveraged by low oil prices). This chain of causation ultimately culminated in declining production rates. Accordingly, the government revenues from UK oil and gas production dropped from an average of around 9 billion GBP in the fiscal years between 2005/06 and 2011/12 to around 5 billion GBP in the fiscal year 2013/2014,[19] showing the impact of dropping production to the fiscal balance sheet of the host state. These statistics do not yet incorporate the recent drops of oil prices, which further contribute to decreasing production and revenues. The latest developments have caused investors to call "for a permanent [tax-] cut of 20 percentage points and the removal of Petroleum Revenue Tax" [20] in the UK.[21]

Besides the "innovative" and partly criticised suggestions made by the Wood Review[22], the UK government was urged to find solutions. Two of these solutions are the so called "Promote-" and "Frontier-Licenses", which were introduced in 2003 and 2004, respectively.

---

[17] Data published by UK government on https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/414172/Production_prjections.pdf.

[18] Oil and Gas Analytical Bulletin May 2014 by Scottish Government, available at http://www.gov.scot/resource/0045/00451335.pdf.

[19] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/383910/UKCS_Tax_Table_December_2014.pdf.

[20] http://oilandgasuk.co.uk/tax-reform-now-crucial-in-salvaging-uk-oil-and-gas-production-from-end-of-decade/.

[21] https://www.energyvoice.com/oilandgas/north-sea/103547/pwc-backs-oguks-call-sweeping-tax-changes/.

[22] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/471452/UKCS_Maximising_Recovery_Review_FINAL_72pp_locked.pdf

Attempted solutions taken by UK authorities

The UKCS licensing regime in principal does not differentiate between on- and offshore blocks. Both on- and offshore operations are governed by a license awarded by the Secretary of State, which is the competent authority to award licenses. It has discretion in the granting of licences in order "*to ensure maximum exploitation of national resource*."[23] Commonly an issued license would follow a standard format consisting of Model Clauses that are set out in regulations (which are varying between seaward and landward blocks). However, the Oil and Gas Authority (OGA) is flexible with this and has discretion to consider adapting new licences to suit special scenarios. Those scenarios are mainly occurring in offshore operations in the northern North Sea and arise out of the special environmental and geographical conditions in that area.

Promote Licence

The Promote License is a variant of the (Seaward) Production Licence and designed "to allow small- and start-up companies a Production Licence first and to attract the necessary operating and financial capacity later."[24] In other words, Promote Licenses are aimed at attracting new investors, a need identified by the PILOT Progressing Partnership Workgroup (PPWG).[25]

The most noteworthy difference from a "standard" license is that the annual rental rate on a Promote Licence is reduced by 90% for the first 2 years, reflecting the reduced financial capacities of small and start-up companies.

Applicants do not need to prove technical and environmental competence or financial capacity *before* award of the licence, however they must do so within 2 years of its start date, as well as having accomplished the agreed drilling/work programme in order to keep the licence, which will otherwise expire. This approach is an attempt to minimise the cost of investing in North Sea in order to attract small and start-up companies that are less financially equipped and that may not be able to prove the necessary technical abilities at the onset of the license, both of which should mitigate some of the risk associated with North Sea operations. The key-terms of this license are as follows:

- Initial term – 4 years (2 + 2 years, initial 2 years reduction of rental by 90%, second half for completion of agreed work programme, after which license will transform into standard license)
- Second term – 4 years
- Third term – 18 years
- Mandatory relinquishment at end of initial term – 50%

6-year Frontier Licence (9-year Frontier Licence)

The Frontier License is another variant of Seaward Production Licence. It is designed to react to problems occurring at the Atlantic Margin, a place of difficult environment, complex

[23] https://www.gov.uk/oil-and-gas-petroleum-licensing-guidance.
[24] Ibid.
[25] http://webarchive.nationalarchives.gov.uk/20101227132010/http:/www.pilottaskforce.co.uk.

geology, and challenging technical hurdles. A Frontier License offers a 6-year exploration phase with reduced rental rates during the initial 3 years, allowing companies to evaluate larger areas for a longer period at a reduced cost, making an investment in exploration and possible production more attractive.

An applicant must prove technical and environmental competence as well as financial capacity *before offer* of a 6-year Frontier Licence is made. The key-terms of this license are as follows:

- Initial (exploration) term – 6 years (of which 3 years at reduced rental without work programme obligations)
- Second (development) term – 6 years
- Third (production) term – 18 years
- Special mandatory relinquishment of 75% after 3 years with a mandatory relinquishment at the end of the initial term of 50% of the remainder (making seven-eighths in total)

The most recent addition to the "bouquet" of the Production Licences is the 9-year Frontier License. It is very similar to the above 6-year Frontier Licence, but features an initial term of nine years, designed to make operations in the harsh West of Scotland more attractive. "Because geophysical data is especially sparse in this region, the OGA expects work programmes to include significant new seismic acquisition."[26]

In summary, the definite success of the above measures cannot yet be proven. However, some figures speak for themselves: within the past 7 UK licensing rounds (21^{st} – 27^{th}) 622 traditional, 361 promote and 34 frontier licenses have been awarded, showing the acceptance of the new licenses and proving the utility of innovation and flexibility.

Conclusions

This article has shown that the situation the UKCS finds itself in is not entirely comparable to the Mexican situation. While Mexico is a new, emerging market and the "new kid on the deep- and ultra- deep offshore block", the UKCS is an "old stager" suffering from problems typical for mature oil fields. Accordingly, the extension and variation of exploration periods, as it has been established in the Frontier Licenses, alone might not be a sufficient amendment to the Mexican legal frameworks. However, the above analysis has also shown that both countries share a common problem, which is promoting investments in the exploration and production of hydrocarbons. Therefore, the experiences made within the UKCS and the UK government's solutions provide at least guidelines for necessary improvements within the Mexican licensing and PSA contract models. The UK's OGA has attempted to attract new investments by introducing additional model licenses, increasing flexibility, and hence receiving favourable reactions from investors. This allows two observations:

Firstly, the UK regulatory authority acted in an investor-friendly manner, acknowledging that investors decide whether exploration and production of hydrocarbons will be undertaken. Of course, whether these initiatives will prove ultimately successful is not yet known

[26] https://www.gov.uk/oil-and-gas-petroleum-licensing-guidance.

Secondly, and inextricably linked to the first observation, it highlights one possible avenue to make investments more attractive, which is to react to the investors needs by amending the legal framework. Hence, the keyword is flexibility, which needs to become an overriding principle in order to promote investments in both the UK and Mexico. As the past months have shown, attracting investors to explore and produce hydrocarbons is one of the problems the Mexican authorities have been facing.

Consequently, the above observations and underlying ideas can serve as a guideline for Mexican authorities to improve the current regimes, be it the licensing regime or the PSA-Model. The idea of a Mexican version of the "Promote License" could be a promising approach in order to attract a wider range of bidders or possible investors, creating more competition in the upcoming bid rounds. The UK's approach to significantly reduce rentals during a specified initial term could be also practicable for the current Mexican legal framework, particularly in the light of the mixed results of the previous bids and low oil prices.

The international oil and gas industry is known for its risk adversity and not for the lust for economic adventures. In order to attract foreign investments and "first-movers", which apparently take higher risks due to a lack of experience in the related frontier area, it is necessary to provide economic incentives that reward the risks taken. The Mexican government should therefore consider adapting provisions of the agreements in place that usually define the economic key parameters of PSAs and licenses. Those are, depending on the contract type, mainly the provisions for cost recovery, government take and royalties, and local content requirements. Amendments should aim at providing economic benefits for first-movers.

In addition, in the mid-term it is worth considering the implementation of a licensing regime comparable to the UK, where on- and offshore operations are both governed by licenses. In other words, in the future, only license agreements should be used by the Mexican authorities. The PSA would be abandoned, as they currently appear to be the preferred choice in developed economies.

In order to be able to react more flexibly to economic and/or political developments, it would be helpful to have optional Model Clauses in place that can substitute for those in the standard licensing agreement, adapting to the particular characteristics of the respective blocks being auctioned. This flexible approach would simplify the current legal framework in the context of a single license regime. And government authorities will be less burdened in administering a license regime, allowing them time to gather experience in the context of this more simple form of contract. Another positive side effect of simplifying the framework is that the process should become more transparent. Flexibility in terms and clauses can still be provided in a transparent way through advance notice and wide publication of them. By providing more flexibility (not to be confuse with political arbitrariness) for potential investors, it will be possible to adapt to the volatile economic environment surrounding long term investments in oil and gas operations. By doing so, the Mexican energy reform in general and the upcoming bid rounds in particular will be able to remain in safe waters leading to success.

Equally important to investors, again in the light of a volatile market, are provisions stabilising and safeguarding the investment under the agreements. Particularly noteworthy are the current dispute resolution clauses. An efficient arbitration clause forms an essential part

of safeguarding investments and investors' interests. The deficiencies in the dispute-resolution provisions has been heavily criticized by others and has been repeated by me in this article. Yet, the deficiencies have not been solved in a satisfactory manner. To be more drastic, the current dispute resolution mechanisms implemented in the model contracts do not comply with basic international standards and fail to satisfy the needs of potential investors. The need to amend these clauses and the underlying federal laws is of paramount importance and should therefore be addressed with priority!

To find more conciliatory words in concluding this article, the amendments to the second bid PSA and the amendments to the Model License Contracts regarding the guarantees and securities, as well as the new national content provisions included in the Model License for the deep water bids, are all illustrating the CNH´s willingness to react to investors´ needs, and can arguably be interpreted as reactions to numerous questions and suggestions put forward within the "*aclaraciones*" (the question and answer program of the CNH). It is likely that these amendments played a role in increasing the number of bids in the more recent rounds, which consequently led to the success of the terrestrial bids. Ultimately, this resulted in a higher number of awarded blocks, meaning higher investments in the Mexican hydrocarbon sector, and in the long run higher government revenues. Additionally, the amendments are a hopeful sign for future cooperation between the regulatory authority and investors as well as for the success of the subsequent bidding rounds.

Last but not least, the problems hydrocarbon producers in the UKCS are facing should be understood as an opportunity for emerging regions like Mexico. Large and small oil companies have already started looking for new options to replace activities in economically less attractive mature regions.