



Private Investment in Mexican Natural Resources

The following is the second chapter in a four-part Commentary discussing the groundbreaking reforms to Mexico's oil and gas sector. The Commentary chapters and their publication dates are as follows:

Part I - Mexico's New Regulatory Framework for Oil and Gas

Part II - Private Investment in Mexican Natural Resources

Part III - Transportation, Refining, Environmental, and Tax—October 2, 2014

Part IV - What's Next for Mexico?—October 9, 2014

A hallmark of the constitutional amendments of December 20, 2013, is the opening of the Mexican oil and gas sector to private participation. The National Hydrocarbons Commission (*Comisión Nacional de Hidrocarburos*, "CNH") now has the authority and ability to grant licenses and to enter into contracts with private investors for the exploration, production, and development of oil and gas in Mexico. Under the reform legislation, these contracts may take the form of profit-sharing agreements, production-sharing contracts, services agreements, or license agreements. The award of the agreements, along with the designation of the geographical areas to which they will apply, will be subject to a public bidding process coordinated by the CNH, with technical assistance from the Ministry of Energy.

The bid procedures and guidelines will be determined by the Ministry of Energy, while the timing and composition of each bid round will be determined by the CNH. Private parties that wish to participate in a bid round must be prequalified. The reform legislation provides that 90 calendar days must pass between the date when a bid round for a specific block is announced (typically through publication in the Mexican Federal Register) and the date when bids are first accepted.

The bid process might take one of the following forms:

- A live auction, where bids start low but get progressively higher until a single bidder prevails;
- A live reverse auction, where bids start high but get progressively lower until a single bidder prevails; or
- A closed auction, where the winning bid is selected from bids submitted in sealed envelopes.

The bidding guidelines will include a tiebreaking mechanism, and the identity of the winning bidder will be published in the Mexican Federal Register.

In addition, private entities, including foreign companies, may invest in shipping companies dedicated to intracoastal navigation and international shipping,

as long as their activities support hydrocarbon exploration and extraction.

Foreign investment will also be permitted in the marketing and sale of gasoline; the distribution of liquefied petroleum gas; the supply of fuels and lubricants for vehicles, aircraft, and trains; the construction of pipelines for the transportation of crude oil and its byproducts; and domestic ground-transportation activities for the oil and gas industry.

Royalties and Government Compensation

The compensation payable to the Mexican government under each contract will be determined on a case-by-case basis and will be set forth in the bid rules applicable to that contract, but the general rules for the allocation of profits and revenue between the private investor and the Mexican government are as follows:

License Agreements in Favor of the Mexican Government

- A signing bonus (to be determined in the bid rules applicable to the contract);
- A contractual fee during the exploratory phase (“CFEP”) (discussed below);
- A royalty; and
- Additional compensation based on the “contract value” of the hydrocarbons produced.¹

License Agreements in Favor of the Private Party

- Title to all oil, gas, and other hydrocarbons once they have been extracted.

Profit-Sharing Agreements in Favor of the Mexican

Government

- A CFEP;
- A royalty; and
- Compensation determined by the application of a percentage to operating profits.

Profit-Sharing Agreements in Favor of the Private Party

- Cost recovery (limited); and
- Operating profits remaining after compensation to the Mexican government has been paid.

Production-Sharing Agreements² in Favor of the Mexican Government

- A CFEP;
- A royalty; and
- Compensation determined by the application of a percentage to operating profits.

Production-Sharing Agreements in Favor of the Private Party

- Cost recovery (limited); and
- Operating profits remaining after compensation to the Mexican government has been paid.

As defined by the secondary legislation, the CFEP is an acreage fee that will be payable to the government for all acreage in the contract area that is not then in production. During the first 60 months of the contract’s term, the CFEP will be charged at the rate of Mex\$1,150 per square kilometer. For the remainder of the contract term, the CFEP will be charged at the rate of Mex\$2,750 per square kilometer.

Under the secondary legislation, the royalty payable to the government will vary according to the type of oil or gas found in the contract area, and will be calculated as follows:

For Oil

- When the “contract value”³ of oil is less than US\$48 per barrel: 7.5%;
- When the “contract value” of oil is equal to or greater than US\$48 per barrel: $0.125 \times [“contract value” \text{ of oil} + 1.5]\%$

For Natural Gas

- For associated natural gas: “contract value” of natural gas/100;
- For nonassociated natural gas:

- When the “contract value” of natural gas is less than US\$50 per MMBTu: 0%;
- When the “contract value” of natural gas is greater than US\$5.00 per MMBTu but less than US\$5.50 per MMBTu: $\left[\frac{((\text{“contract value” of natural gas} - 5) \times 60.5)}{\text{“contract value” of natural gas}}\right]\%$
- When the “contract value” of natural gas is greater than or equal to US\$5.50 per MMBTu: “contract value” of natural gas) / 100;

For Natural Gas Liquids

- When the “contract value” of natural gas liquids is less than US\$60 per barrel: 5%;
- When the “contract value” of natural gas liquids is greater than or equal to US\$60 per barrel: $[(0.125 \times \text{Contractual Price of Condensed Hydrocarbons}) - 2.5]\%$

Land Use and Legal Easements

The Hydrocarbons Law introduces for the first time in Mexico a mechanism for a private entity to obtain a “legal easement for hydrocarbons” (*servidumbre legal de hidrocarburos*), which is essentially a right of way for oil and gas infrastructure, for the transportation, handling, placement, or storage of materials and machinery required for the construction, installation, and maintenance of that infrastructure, and for exploration and production projects.

The underlying principle of the easement is that landowners and companies holding the right to develop oil and gas resources should first attempt to negotiate the terms (including compensation) of any necessary easements or rights of way. If the landowner and the company are unable to reach an agreement, then the company may: (i) seek a legal easement for hydrocarbons from the relevant district judge; or (ii) apply for mediation by the Institute of Administration and Appraisal of National Goods (*Instituto de Administración y Avalúos de Bienes Nacionales*, “INDAABIN”).

As part of the mediation process, the INDAABIN will ask two experts to perform an appraisal of the value of the right-of-way and the affected property. If the difference between the two experts’ findings is less than 15 percent, then the compensation to the landowner will be the simple average of the two appraisals. If the difference between the appraisals is 15 percent or more, then a third expert shall be engaged, and the compensation payable to the landowner will be the average of the three. If either or both parties do not accept the compensation proposed by the INDAABIN, the dispute may be submitted to the Ministry of Energy to begin the process for judicial expropriation of the property.

The Law of Hydrocarbons provides that the compensation payable to landowners for the use of the surface should cover:

- Payment for actual impairment of the land or to the development of goods from that land, as well as liquidated damages;
- Rent for the occupation and use of the land; and
- Onshore exploration and production projects will be required to pay a percentage of profits to the landowners, ranging from 0.5 percent to 2 percent for oil and other hydrocarbons and from 0.5 percent to 3 percent for nonassociated natural gas.

Compensation may be paid to the landowner in the form of development projects that benefit the affected community (e.g., roads, schools, hospitals, etc.), through any other compensation that is not prohibited by Mexican law, or through a combination of the two.

Mining companies will also be affected by the new oil and gas regime in Mexico, which now gives preference to the exploration and production of hydrocarbons over any other activity. Mining companies will be entitled to the same compensation as any landowner, as described above, but may also receive a 0.5 percent to 3 percent profit share of non-associated natural gas or a 0.5 percent to 2 percent profit share of all other hydrocarbons.

Lawyer Contacts

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our “Contact Us” form, which can be found at www.jonesday.com.

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Endnotes

- 1 The term “contract value” will be calculated according to the then-current market rate for oil and gas. The precise calculation methodology for each contract may vary and will be established in the terms and conditions of the contract itself.
- 2 While the typical compensation structure under a production-sharing agreement consists of payment to the government of a signing bonus, a percentage of “cost oil,” and a percentage of “profit oil,” with the private investor keeping title to the remaining oil and/or gas production, the Hydrocarbons Law lists virtually the same compensation structure for profit-sharing agreements and for production-sharing agreements. Currently, the only difference is language in the Law’s description of a profit-sharing agreement providing that the government’s compensation will be in the form of goods, rather than money. The distinction between production-sharing agreements and profit-sharing agreements in Mexico will hopefully become more clear in the near future, either through the bid rules, model contracts, or otherwise.
- 3 As mentioned above, the “contract value” will be determined by applying calculation methodology that contemplates the then-prevailing market price for oil or, as applicable, natural gas, together with several other factors. The precise methodology for each contract will be specified in the contract and the bidding rules.