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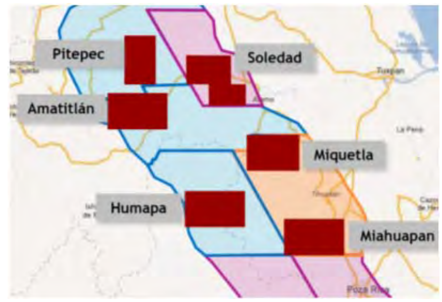
Houston, July 17, 2013

Pemex's Third Bid Round: Chicontepec

Pemex was hoisted on its own contractual petard

ON JULY 11, 2013, PEMEX TOOK ITS THIRD STEP toward implementing its ten-year farm-out strategy that began with the Multiple Service Contracts of 2003. An auction was held at Pemex's regional headquarters in Poza Rica for a financial interest in future production in six blocks in the nearby province known as Chicontepec.



The contract model was designed to align the interests of Pemex in increased oil production in marginal fields with the interest of the contractor to derive incremental profits from fees linked to production. The contractor's interest in the revenue stream from production would be limited to a fee-per-barrel.

As had occurred during the previous auction, there were blocks in the auction that received no bids: two in 2012, three in 2013. The surprise in 2013 was that some bidders deployed an unimagined bidding strategy: do the work for free—or almost. The winning offers (in US$/barrel) were these: 1 cent (**Halliburton**), 49 cents (**Petrolite**) and 94 cents (**Diavaz**).

The new bidding strategy exploits a loophole in the current, revised contract and allows bidders to ignore Pemex's maximum tariff. This report examines the problematic consequences for Pemex and traditional oil companies that are likely to follow from the use of this alternative business model.

A parallel concern is about the tax implications of the Chicontepec awards. We reluctantly conclude that auctions of this type be suspended until after the energy reform package is approved.

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Summary

Pemex now has a decade of contractual experimentation in which the goal has been to see if it is possible to attract IOCs to Mexico as Pemex contractors without offering a mineral interest in production (and, by extension, commercial rights). The outcome of the bidding in the Chicontepec auction continues to show that the answer is negative.

During 2003-05, companies were offered the opportunity to operate in the Burgos Basin on the exclusive basis of reimbursable costs; but this framework was unattractive to major oil companies. In 2010, the concept of a fee/barrel was introduced with partial reimbursement of expenses.

The innovation of 2013, namely, 100% of cost reimbursement for an extended period, has backfired: the winning bidders are looking for their profits through cost reimbursement, with the fee/barrel relegated to secondary consideration. The Pemex auction for the Chicontepec area revealed a bidding strategy previously not seen in earlier bid rounds: the winners of the three blocks that were awarded offered to do the work for free (or almost), with bids of US$ 1 cent, 49 cents and 98 cents.

By coincidence or collusion, the winning contractors had the same bidding strategy, which did not exclude, however, the option to compete against each other (as was seen in the bidding for the Humapa and Miquetla Blocks).

The winning bidding strategy sets a problematic precedent:

1) It introduces a business model that fits large oilfield service companies with diverse business lines or those oil companies that own rigs or have in-house services such as drilling, wire line, fracturing and mud pumping.
2) The business model of the traditional oil company is further marginalized.
3) The economics are non-transparent, as the profit margins will be achieved in the pricing of the supplies, tools, services and technical support that the service companies will obtain from affiliated companies.
4) The virtually for-free bidding strategy makes Pemex's "maximum fee" irrelevant.
5) As the project economics will be driven by built-in profits from a service company's product catalog, there will be no revenue cushion for experimentation or unscheduled requirements related to technology, infrastructure, safety, security, and environmental protection or community relations.
6) There is little incentive for the contractor to increase production beyond the level at which profit margins are met through intra-firm commerce.
7) Payments to the contractor on the basis of cost reimbursement will be untaxed in Mexico. Tax liability by the winning Mexican company will be on the basis of the minimal revenue that will be generated by the incentive fee.

Market Note 171 - Titles of related MEI reports

File #	Published	Updated	Topic	Pages	Table/ graph
100165	• Apr 27, 13	May 15, 13	Benchmarking Expectations for Mexican Energy Reform (Part I): Market Dynamics One useful way to understand the evolution of the Mexican economy in general and the development of the energy sector in particular is to view the period since 1959 as a Import Substitution Stratgegy. In late 1958, the Congress passed a new Petroleum Law that effectively eliminated the legal figure of a private oil mineral interest. In so doing, one of the four elements for a successful oil industry was removed: private economic incentive. The other three elments--talent, technology and financing--were to be sought via a STEM curriculum at the IMP and IPN, CONACYT scholarships, IMP research and foreign debt.	8	0
100154	• Jan 10, 13		The Logic and Options for Energy Reform in Mexico As candidate in 2012 and as president in 2012, Enrique Peña Nieto has indicated that he will seek an energy reform. What ideas for energy reform have circulated in Mexico during prior administrations? Tables 1-4 of this report offer a 16-page catalog of those ideas. Table 1 lists ideas already put into practice; Table 2 are ideas that were not implemented; Table 3 are ideas from civil society, and Table 4 are ideas that have been voiced in public and private venues by the global oil and power industries. The report argues that Pemex and CFE should be prepared for roles as operators outside of Mexico. One conclusion is that if a reform only makes Pemex more efficient in Mexico, it is not worth the effort.	9	17
100133	• Jul 04, 12	Jul 17, 12	Pemex's Mature Fields Auction (Round 2): What Went Wrong? The Pemex 2nd round of bidding for the six blocks in its Northern Region was a disappointment: First, no IOC submitted a bid, which was particularly painful in relation to the Arenque Block, whose bid package Chevron had purchased. Neither of the 2 offshore blocks were awarded, on questionable grounds in each case. Mexico's bid round held on June 19th earned just $40 million; the US GOM bid round, held on June 20, earned US$2.6 billion. The report urges a legal review of aspects of Pemex’s bid protocols.	9	2
100131	• Jun 27, 12	Jul 3, 12	Chevron and the Seven Dwarfs: An Upstream Fairy Tale A saying in Mexico is that “Truth is told in fiction, while fiction is told in truth.” A critique of Pemex’s second bid round, which culminated in awards on June 19, 2012, for four of the six blocks, is told in the language of a fairy tale of the Middle Ages.	13	0
100111	• Feb 02, 12		Pemex's Farm-Out Program: How to Evaluate Its Efficiency? This report proposes that the term "farm-out" best captures the sense of Mexican energy policy since 1992 in power, gas and the upstream. The report examines alternative approaches to evaluating the success of the decade-old farm-out program in Pemex E&P, a program that, to date, has yet to be evaluated by Pemex's board or auditors from the government (SFP) or Congress (ASF). The report provides several optics by which the success of the program may be evaluated.	19	3

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File #	Published	Updated	Topic	Pages	Table/ graph
100100	• Oct 31, 11		The Oilfield Service Market After Santuario This report argues that the structure of the oilfield services market was significantly altered as a result of the outcome of the bidding for the Santuario Block in Pemex's first round of public tenders. The 9 bids submitted on August 18, 2011, fell into three distinct groups, of which the most competitive was the subset that offered bids that were a technical tie. The report concludes that the bidding protocols and awards protocols were inefficient, with the exception of making the identity of the losers transparent.	6	3
100096	• Aug 21, 11	Dec 21, 11	Pemex's Mature Fields Awards The work of over a year by Pemex's Office of New Ventures produced a measure of success on August 18, 2011, when 11 companies presented bids to redevelop 3 blocks under the terms of a new, and untested, commercial model that provides payment to contractors on the basis of a fee/barrel. This report identifies the legal and institutional drivers at work behind the protocol; it also asks about the disadvantages to Pemex of a “lowest-price” approach to selecting EP contractors. Can the model be used outside of PEP?	12	5

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