

PUBLIC POLICY PERSPECTIVES are issued periodically, in English or in Spanish, as a public service with the aim of inviting fresh discussion of matters of politics, law, policy, regulation and corporate governance. This document was prepared to provide an orientation regarding international understandings of a farmout agreement.

PEMEX’S FARMOUT STRATEGY: INTERNATIONAL EXPECTATIONS

The logic and terminology of Pemex’s deep water strategy

DURING PEMEX INVESTMENT DAY held in London on October 6, 2015, Pemex’s Gustavo Hernández unveiled his company’s vision of an aggressive farmout program that could attract upwards of US\$50 billion. He informed the audience that Pemex had identified 17 fields that were considered for farmouts. These fields were identified as “assets considered for partnership with Pemex.” What the slides did not show was the unique type of partnership that Pemex seeks by a farmout agreement.

The present report does not aspire to read Pemex’s mind regarding its understanding of the commercial arrangement in the oil and gas industry that is known as farmout; instead, it offers a perspective on how the concept and its associated terminology are understood outside of Mexico, particularly in relation to usage in federal waters in the U.S. Gulf of Mexico.

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- PEMEX’s Reserves
- Migration Status
- Farm-outs
- Round One
- Strategic Assets and New Developments
- Collaboration and Association Agreements
- Production Objectives

List of topics, London, Oct. 6, 2015

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The central idea is that it is a contract by which the owner or leaseholder of oil and gas rights offers to convey his legal interest to a third party upon that party’s completion of specified activities (such as drilling a well to a certain depth). In parallel, a farmout relationship creates for the owner or leaseholder the option to later join in the project should it have as strong hydrocarbon potential. There are advantages for both sides.

Exhibit A is a glossary of a dozen terms associated with farmout agreements. Exhibit B is an illustrative letter of inquiry from a prospective farmee.

PEMEX'S FARMOUT STRATEGY: INTERNATIONAL EXPECTATIONS

The logic and terminology of Pemex's deep water strategy

THIS POLICY PERSPECTIVE EXAMINES the commercial logic and terminology of a farmout agreement as it is commonly understood in the oil and gas industry in the United States.

SUMMARY

A farmout agreement is a contract with if/then clauses. For many possible reasons, the owner or leaseholder of a mineral estate seeks another party to determine if there are commercial hydrocarbons in the area of his property or lease. The reason for his choosing a farmout, as distinct from a sublease, is that the owner or leaseholder wants to create the option of converting a royalty payment (should hydrocarbons be discovered) into a working interest in the well or project.

Without introducing any more complexities to the story, it's quite easy to see how Pemex would wish to leverage its Round Zero acreage in ultra-deep water near the U.S.-Mexico maritime border by offering a farmout agreement to qualified oil companies. If the companies (now "farmees") find oil in commercial quantities, then Pemex will have negotiated a provision by which it could convert its royalty into a working interest in the well. In this way, with little or no additional capital outlays, Pemex can gain an interest in a well that could have easily cost US\$250 million to drill and complete.

It sounds too good to be true, and future events may show us why it was so. Meanwhile, we may consider that no such contract with if-then clauses of this type has ever issued by Pemex or any other agency of the Mexican government. Further, our review of the terms and concepts of the hydrocarbon legislation and regulations issued since 2014 gives us scant room for optimism that the farmout paradigm can be accommodated in the Mexican framework as it now stands.

But we are getting ahead of ourselves: The first order of business is to understand the commercial logic and basic terminology of a generic farmout agreement.

INTRODUCTION

IT IS SAID THAT THERE IS NO SUCH THING as a "typical" farmout agreement, as the motivations, terms and conditions vary so widely. Leaving aside such details, the central idea to be understood is that the use of such an agreement is a strategy on the part of the party that has a lease or other conveyance of mineral rights

- 1) to entice another party to assume the risk and cost of exploration and development,

- 2) with the aim in view of creating an option to back into the well or field by converting his overriding payment into a working interest.

The decision to employ a farmout strategy by Pemex was a creative leap into the future, that is, given that the legal framework did not contemplate a farmout relationship by which a second party's interest in the mineral estate would be vested only after specified work obligations had been accomplished.

The farmout concept is scarcely known in Mexico. In a recent survey of 68 press articles that had been submitted for a contest for excellence in Mexican journalism, the term "farmout" occurred in a passing reference in only one article.¹

"A farmout agreement is an agreement to assign an interest in acreage in return for drilling or testing operations on that acreage." This definition, from John Lowe's *Oil and Gas Law*, published in 1995, would, twenty years later, be regarded as incomplete.

Basically, there are two parties to a farmout agreement: the first party either a) owns the mineral estate outright or b) has a conveyance of one kind or another (as by a license or lease) of exclusive commercial rights and obligations within an area defined in either two or three dimensions for a specified period of time.

It is understood that the scope of "commercial rights" includes the activities of exploration, including drilling, extraction and marketing; obligations include responsibility for safety and environmental incidents and eventual decommissioning.

To appreciate the function of a farmout agreement in oil industry worldwide, it will be useful to survey the motivations of each party and have a familiarity with basic terms.

DISCUSSION

TO REPEAT, WE ARE NOT TRYING TO READ PEMEX'S MIND in relation to what is, or is not, understood by Pemex in using the technical term farmout² and we leave it an open question as to what is meant by "Partnership with Pemex."

MOTIVATIONS

Pemex has conducted operations in Mexico for more than seventy years without using the term "farmout"; so it is a reasonable question to ask, *why now?* The shape of an answer may emerge as we become better acquainted with the subject.

¹ http://www.milenio.com/firmas/george_baker/Aplausos-reganos_18_655314473.html. The review of the press articles was in connection with a contest that was sponsored by **Gas Natural Fenosa** for excellence in energy journalism in Mexico.

² Spelled "farm-out" in Pemex documents.

Farmor

A useful way of understanding the commercial logic in favor and against a farmout is to consider two situations:

- 1) A Texas rancher has a property whose mineral rights have not been severed from his surface rights and who is keen to know if there are oil, gas or shale deposits on his property. He is approached by an oil company that offers to *lease* his mineral rights in exchange for a royalty. The rancher is a cattleman, not an oilman; he is not interested in a contract that would create a future investment option by which he would assume liability for a share of costs of operations. Instead of a farmout contract, he prefers to lease his mineral rights to an oil company.
- 2) An oil company has acquired a lease either from a Texas rancher or in a U.S. government auction in the Gulf of Mexico. The company's strategy is to obtain a working interest in future discoveries on its block, but it is not willing to risk the necessary capital to invest in the drilling of one or more exploration wells to evaluate the hydrocarbon-producing potential of the block.³ The oil company is the *farmor*.

Because it wants a working interest in any successful well, the oil company chooses a *farmout* over a *sublease* (which does not offer this opportunity). By a farmout, the leaseholder (as a generic term) negotiates with another oil company (called a *farmee*) terms by which, the *farmee*, upon performing certain obligations (as in drilling a well), acquires an interest in the lease. The terms further provide that if a commercial discovery is made, the *farmor* is to receive an overriding interest payment. Most importantly, once the *farmee* recovers its costs (during the Payout Period), the *farmor* has the option *to convert his override into a working interest*.

In parallel, the company wants the option to decline the conversion option, keeping its overriding royalty.⁴

There could be additional motivations:

- 1) The company has producing wells to 10,000 feet, and has no intention of assuming the risk of drilling deeper. He would be motivated to have incremental barrels from producible

³ And, as with Pemex in Round Zero allotments in the ultra-deep waters of Perdido, it may have never been the company's intention to drill and develop its blocks in that area on its own.

⁴ There could be multiple reasons for declining the conversion options: the *farmor* may not see a sufficiently attractive risk/reward outlook for the wells, noting (as one consideration) that the *farmee* may be soon faced with the need for costly investment in secondary or tertiary recovery.

formations that might exist at greater depths. In such an agreement, the farmee's commercial rights would begin at a depth greater than 10,000 feet.

- 2) He has inadequate capital and/or expertise to develop any of the areas, and seeks another party to execute what he, himself, cannot do or is unwilling to do based on the risk to be undertaken, reserving for himself the right to convert his overriding interest into a working interest should drilling prove successful.⁵
- 3) A farmout option may be a strategy to avoid relinquishment of an area as required by the terms of an agreement or contract in relation to portions of a block that are not under development.

Recalling the adage that "oil is first found in the minds of geologists," it should be clear that the motivation of a party in seeking a farmout agreement need not always be future production. It may be driven by an idea about the depth or extension of a petroleum system, the existence of which is inferred using either (a) extrapolated data or (b) a geological analog.

From the perspective of either party, a well that is drilled to validate an idea may be deemed successful even if no commercial quantities of hydrocarbon are discovered.

Farmee

The other party may seek to have access to a portion of an owner's or lease-holder's geographical area (as defined in two or three dimensions) for diverse reasons:

- 1) It is the company's line of business; that is, it actively seeks farm-in opportunities that would create a working interest in a well or wells.⁶
- 2) He seeks to test one or more geological hypotheses, or ideas, so it's premature to negotiate a sublease.
- 3) He seeks new production and revenue by employing the rigs and crew presently available.
- 4) He seeks to optimize the usage of his nearby infrastructure by adding incremental barrels.
- 5) He seeks access to acreage that may not be otherwise available and which may be available at a lower cost.

Phases of a farmout

A farmout agreement establishes three phases in the relationship between the farmor and farmee: 1) Earning Period 2) Payout Period and 3) Conversion Option Period. The third phase is the shortest, perhaps a matter of a single month: During this time the farmor decides whether or not to convert a

⁵ This is the motivation of Pemex in blocks in deep water and in relation to extra-heavy blocks in shallow water.

⁶ An example is **Challenger Minerals, Inc.**, a **Transocean** subsidiary that was dissolved after the Macondo incident of 2010. Ron Smith, its international business development consultant, told us that the company would annually evaluate dozens of farm-in opportunities worldwide (with the proviso that Transocean rigs would be used).

royalty payment into a working interest in the well, basing his decision on his assessment of the outlook and economics of the well, drawing on subsurface data and reports that are supplied by the farmee.

The first phase is one in which the farmee is obligated to perform certain activities as a condition for being invested as a mineral owner or as a party to a license issued by a government.

The second phase begins only if, as a result of having performed those activities, the farmee determines that there are commercial deposits and that he is prepared to invest in their production. A portion of the revenue generated during this phase is

paid as a royalty, or overriding interest, to the farmor. Profits (gross or net, as negotiated) are credited to a Payout Account, which is nothing more than a running account of costs that are to be reimbursed. Funds in this account accumulate until the cost of the investment and operations as required by the agreement is reached.

In the period that follows the time for the conversion option, the farmor's relationship to the farmee is, as before, with only an override royalty or as a participant in the lease with a working interest.

Illustration of a letter of inquiry by a prospective farmee

The initiative for starting negotiations leading to a farmout agreement may come from either side. The owner or leaseholder may seek one or more farmees (as will be Pemex's case) or a prospective farmee may approach a mineral owner or leaseholder (See illustration in Exhibit B below).

OBSERVATIONS

IN A SEPARATE REPORT,⁷ we shall examine the legal and regulatory framework as given by the Hydrocarbon Act of 2014 and related legal and institutional dispositions to assess the extent to which the terms and concepts described in the present report are compatible.

⁷ MEI Report 799 "Outlook for Pemex Farmouts: Legal Considerations" (in preparation).



Concern has been heard in Mexico from translators and others who have wondered how can “farmout” be translated into Mexican Spanish. While some voices say “leave it in English,” others are concerned that the central strategy of Petróleos Mexicanos in deep water areas needs to have a specific name in Mexican Spanish. At a conference in 2012, the Pemex director general was heard to say *farmoutear*.

Looking back, Pemex during the decade 2003-13 was experimenting with business models that resembled farmout agreements in several respects: contracts were of the risk-service type, meaning that the contractor would be paid as a function of incremental production. Unlike a true farmout agreement, however, the contractor would never be vested with commercial or mineral rights. Further, the contractor’s assets would be limited to Pemex receivables, never oil and gas reserves.

CONCLUSIONS

PROVIDED THAT THE FARMOUT PARADIGM can be adapted into Mexican law and regulation, its use as a low-cost strategy to attract capital, expand its portfolio and gain experience is a reasonable gambit.

From the viewpoint of the perspective farmee who is a major international oil company with experience operating in frontier exploration and deep water areas, the attractiveness of a Pemex farmout offer will be determined by considerations of three kinds:

- 1) Geologic attractiveness: The materiality of the opportunity being offered, that is, its quality (size and risk).
- 2) Legal security: The strength before the law of the conveyance of rights to explore for, develop and extract oil and gas in the Contract Area; that is, real property rights that are recognized by Mexican courts.
- 3) Economic attractiveness, including the ability to post, as reserves, the success of exploration efforts in the Contract Area in which Pemex may have converted its royalty or overriding royalty interest to a working interest.⁸



About this Public Policy Perspective

This report was motivated by the stark asymmetry between the importance of the commercial figure of farmout for Pemex in deep water blocks, and the lack of familiarity in Mexico in government, media and academic circles with the concept and its advantages. The report could not have been written without the benefit of the guidance of industry professionals with experience in farmouts. El Limpiador improved the report by both critiquing the logic and proofreading the text.

⁸ In which case it would post, as its reserves, volumes corresponding to its proportional interest in the Area.

Exhibit A

GLOSSARY OF FARMOUT TERMS⁸

Prospect

A prospect is a drill-ready area where commercial quantities are expected to be located.

Record-title interest owner

The party that has the exclusive legal right to drill an exploratory well in a defined geographical area and depth and to produce such hydrocarbons as may exist in commercial quantities.

Farmor

The record-title interest owner.

Farmee

The party who, under an agreement with the farmor, is given the opportunity to explore for hydrocarbons in all or a portion of the area to which the record-title interest owner has rights. The area may be defined geographically or by both geography and depth. By this agreement, the farmee, if successful in discovering hydrocarbons in commercial quantities, will receive a conveyance of a direct or indirect interest in the mineral estate. An indirect reference is one that refers to rights to explore and extract, not to the minerals themselves (see Title Conveyance).

Drill to earn

By this agreement, the farmee is required to drill (or complete) one or more wells. If successful in discovering hydrocarbons in commercial quantities, the farmee will receive a conveyance of an interest in the mineral estate (if owned in fee simple) or as an interest in the lease or license (if in a jurisdiction in which a government is the mineral owner).

Record title

Since the Macondo incident of 2010, it is the common practice of a farmor to transfer full title to the mineral estate during the period of exploration. The reason for this practice is to avoid liability should an incident occur, given that the “jointly and severally” clause in a contract would make the farmor liable for 100% of the cost of an incident were he even to have only a 1% interest in the lease.

Earning Well

The initial well (or wells) that is/are drilled (or completed) by the farmee will determine if he obtains the conveyance of title to an interest in the mineral estate. If no commercial quantities are found, then the farmee is obligated to return the record title to the farmor, and no residual assets are acquired.

⁸ Our understanding of these terms derives from industry sources most of whom spoke to us on background, that is, not for citation. In this report, special thanks go to Michael Murphy, a U.S. lawyer who resides in Mexico City and who called our attention to several legal dictionaries where “farmout,” “farmoutee,” “farmoutor,” among other related terms, are defined. Examples include *Dictionary of Modern Legal Usage* (Oxford, 1995) and *Black’s Law Dictionary* (7th Edition), both edited by Bram A. Garner. She observes that the translation of “farm out,” as given in Wiley’s *English-Spanish and Spanish-English Legal Dictionary* (1995) as *dar por contrato*, *arrendar* and *subcontratar* fails to convey the legal meaning, adding that “arrendar” (to lease) is politically problematic in Mexico.

Over-riding royalty

The farmor will require a royalty payment from the contractor equivalent to a certain percentage of gross or net earnings (as negotiated).

Delay rental fee

In relation to oil and gas acreage on federal lands and waters, there is an annual rental fee assessed on each acre of the lease. In the event of a commercial discovery and development, the farmee will be held responsible for payment of this fee.

Payout

With a commercial discovery, the farmee is entitled to a recovery of his costs which may or may not include taxes and rental fees (as negotiated).

Working interest

The ownership of a lease (as a generic term) is divided among parties as a percentage. A lease-holder (used as a generic terms) of a given percentage has obligations, liabilities and benefits.

- 1) The obligation to contribute capital in due proportion to pay all costs incurred with the operation of the field, including drilling and plugging wells, cleaning up the drill sites and decommissioning of production infrastructure as may be required. The leaseholder has a liability the cost of a safety or environmental incident.
2. The right to receive share-holder distributions in proportion to the percentage of working interest.

Working-interest option

The farmor will normally maintain the option, at payout, of converting his over-riding royalty into a working interest in the project. Were he to exercise this option in favor of a working interest, the parties would be governed in the future by a Joint Operating Agreement (JOA) and the farmor (now an equity participant) would pay his share of future costs, and, as above, be liable for that portion of the costs, equivalent to his interest, of a safety or environmental incident.

Back-in option

This option would require the farmor to pay a portion of the sunk costs to date equivalent to the working interest to be obtained.

Conveyance of working interest

In most jurisdictions worldwide, minerals under lands and waters are owned by the central or provincial government. In such a jurisdiction, a license conveys exclusivity of drilling, extraction and commercial rights to hydrocarbons in an area defined geographically and vertically. The conveyance does not refer to the molecules of oil and gas, but to the exclusive right to find and extract them within a specified period of time.

The legal nature of this conveyance is such that it is regarded as valid in a court of law in the host country and before an international arbitration panel independently of the financial or legal situation of the farmor. (Hypothetically, the farmor might have gone into bankruptcy or ceased operations entirely).

XYZETA CORPORATION

1000 Smith Street
Houston, TX 77002

December 14, 2015

Mr. G. Baker
G.Baker Corporation
Box 271056
Houston, TX 77277-1506

RE: **PROPOSAL TO NEGOTIATE
GREEN CANYON BLOCK 1016**

Dear Sir:

XYZETA Enterprise (“XYZ”) hereby requests a farmout from G. Baker Corporation (“GBC”) of its interest in OCS-G 18391 (“Lease”) covering Green Canyon Block 1016 (the “Farmout Area”) under the following general terms and conditions.

1. On or before July 31, 2016 (as such date may be extended by the parties upon written request from XYZ for additional time due to unavoidable delays caused by weather, loop currents or eddies, or other force majeure conditions provided the BSEE has granted an SOO) XYZ at its sole cost, risk and expense, shall commence or caused to be commenced at a location of its choice the actual drilling of the initial earning well (“IEW”) on the Farmout Area. After commencing drilling operations in the IEW, XYZ shall thereafter, with due diligence and in workmanlike manner drill and log said well to the lesser of (i) a depth of approximately 31,000’ total vertical depth (“TVD”); or (ii) a depth to test the Middle Miocene formation (the “Contract Depth”).
2. If XYZ encounters conditions and/or develops mechanical difficulty in the IEW prior to reaching Contract Depth that, in XYZ’s sole opinion, renders further drilling impractical or impossible; XYZ shall have the option, but not the obligation, to commence or cause to be commenced, within one hundred eighty (180) days from (i) abandoning the IEW or (ii) from rig release of the IEW, whichever occurs first, the actual drilling of a substitute well. The right to drill substitute wells shall be a recurring right.
3. GBC shall be entitled to receive, at no cost, a copy of the daily drilling report and any and all well data, analyses and/or information obtained and/or derived from the IEW and/or its substitute, if applicable, as if GBC were a participating party in the IEW. Any and all data derived and/or provided shall be considered confidential information and shall be treated as such by GBC. Until such data becomes available in the public domain (other than as a result of wrongful act or omission of a party), GBC shall not reveal, copy, disclose, transfer, assign, dispose of and/or convey the data provided hereunder in any manner to a third party without the written consent of XYZ.
4. Should XYZ timely commence or cause to be commenced the actual drilling of the IEW and/or its substitute, if applicable, and drills at least to Contract depth, then said IEW (or its substitute, if applicable) will thereafter be referred to as “Earning Well”. Upon XYZ (i) drilling and evaluating the Earning Well (ii) providing GBC with the well data that has been obtained by

Exhibit B

December 14, 2015

Page 2 of 2

and in possession of XYZ (iii) and otherwise complying with the general terms and provisions of the farmout agreement, XYZ shall be deemed to have earned as assignment from GBC on one-hundred percent (100%) of eight-eighths record title in and to the Lease, as to all depths (herein after referred to as the "Assigned Interest").

5. As further consideration for the farmout GBC shall reserve unto itself a net six percent (6.0% of 8/8ths) of eight-eighths overriding royalty interest ("ORRI") in the Lease. GBC also warrants that the only burden besides the ORRI on the Lease is the one-eighth of eight-eighths royalty burden in favor of the Lessor.
6. During the term of the Farmout Agreement, XYZ will reimburse GBC the full delay rental of \$57,600.00 due under the Lease accruing after the effective date of the Lease.

This letter is further subject to the following:

- A. Each party shall bear its own evaluation, consultant, legal, and other expenses associated with any evaluation, discussion, and negotiations concerning any agreement contemplated herein.
- B. This proposal is only a basis for negotiations and is not an agreement or contract, and in no event will any of the undersigned parties be obligated to one another with respect to the project or transaction unless and until a definitive agreement is fully executed in a form and substance acceptable to each of them. It is recognized that unless and until a definitive agreement has been executed, no party shall be bound or obligated to proceed in any manner whatsoever, and any party may terminate negotiations without liability at any time for any reason.
- C. The terms outlined herein and any agreement contemplated herein, is subject to final corporate approval by the appropriate levels of XYZ and GBC. Such approvals are not assured, and if any requisite level of management or corporate approval is not forthcoming for any reason whatsoever, no party shall be obligated to seek other such approvals.
- D. This proposal supersedes all prior communications concerning the subject matter hereof.

Due other commitments currently contemplated, we will need to finalize a formal agreement no later than January 15, 2016. If you are interested in furthering discussions along these lines, please contact the undersigned at your earliest convenience.

Sincerely,

T. U. Veras, P.E.
Offshore Land Manager



Selected MEI report titles related to Pemex's farmout strategy

Year	Topic	File #	Pages	Chart
2015				
May 18, 15	The Farmout Opportunity in Mexico: The Pillar of Pemex's Frontier Strategy Until September 13, 2014, the oil industry term "farmout" was all but unknown in Mexico. On that date, in a briefing at the Energy Ministry, it was revealed that 4/5ths of the properties for which Pemex had received permits for exploration and extraction would continue to be under Pemex's operatorship; some of these properties, however, were labeled as "farmouts." Those properties included mature fields as well as frontier plays in heavy oil, deepwater gas and deepwater oil. This report examines the nature of a farmout agreement as understood outside Mexico. Pemex's negotiating options are presented.	783	8	3
2012				
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.	100111	19	3

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