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PUBLIC POLICY PERSPECTIVE No. 10037

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 call attention to the need to include Pemex blocks in auctions in parallel to those of the deep water Round 1.4.

PATHS TO PEMEX PARTNERSHIP

Farmout, Cash Sale and Carried Interest

THE IMPLEMENTATION OF THE UPSTREAM REFORM in Mexico is supposed to be about the auctioning of the blocks that were not reserved to Pemex--plus bringing selected Pemex's blocks into commerce in associations with other oil companies. The fact that the government in 2015 held three auctions with non-Pemex blocks does not compensate for the failure to devise paths to partnership with Pemex. Such partnerships would need to be on the basis of a working interest in the lease that Pemex held with the government (as the mineral owner).

The upstream reform was to include partnerships in Pemex blocks, not only auctions of government blocks

Pemex's leases amount to some 83% of Mexico's proved reserves. Of these leases, 22 are currently being operated on the basis of risk-service contracts with upwards of a dozen companies, including **Lewis Energy, Petrofac, Grupo Diavaz** and **Halliburton**, among others. This type of contract means that the operator has no interest in the lease, hence, no direct commercial interest in production and no motivation to increase it or make it more efficient.

It was the intent of Pemex to renegotiate these contracts into the forms of association in which Pemex would trade all or part of its leasehold interest in exchange for certain benefits, chief among these would be infusion of capital with the opportunity to participate in the current or future revenue stream.

For diverse reasons, negotiations proved much more difficult than had been imagined, and the process of renegotiation—termed "migration," as if it were a straightforward process—has stalled.

As for the rest of the portfolio of Pemex, beginning in August of 2014, Pemex announced that it had identified 17 blocks as candidates for a type of contract known as "Farmout." The alternative to Farmout is a Production Sharing Agreement (PSA) by which Pemex would convey title to a portion of its lease to another oil company. A variant of PSA is known as Carried Interest.

Contents

This public policy report explains the essential differences between Farmout and PSA, and lists the advantages, disadvantages and biddable variables of each (Table 1).

DISCUSSION

AN APPRECIATION OF EACH OF THE TOPICS touched upon in this section is important for an understanding of the situation facing Pemex and the government.

Alignment of interests

The unique challenge is devising an alignment of interests between Pemex and the government.

The government wants to accomplish these goals:

1) Maximize revenue for the State
2) Control the process of partnership selection by requiring that Pemex blocks be awarded by public auction.
3) Have the outcomes of the auctions be favorable for the development of Pemex as an oil company and be complementary to the results of the auctions of non-Pemex blocks.

Biddable variables

For a public auction, there must be biddable variables. The government's goal of maximizing State revenue is not appropriate in devising biddable variables for Pemex, as the company also has to make a profit from partnerships.

Again, the process seems to be stalled, as disagreements between Pemex and officials in the energy and finance ministries have not yet been resolved.

Renegotiation of risk-service contracts

The renegotiation of the risk-service contracts would entail complex considerations:

1) The determination of the share of working interest that each party would receive, taking into account the value of the reserves for which the contractor had been responsible and the facilities in which investments had been made.
2) The terms of the joint operating agreement (JOA).
3) The present account balance due the contractor from Pemex.
4) The fiscal terms imposed by the Finance Ministry.

Partnership options

Partnerships are all about sharing risk and resources to reward multiple investors. The ranking of how those risks and resources is distributed is seen in the percentage degree of working interest in a lease: the greater the working interest, the greater the risk and reward.

Operatorship

A primary consideration in the choice of the type of partnership revolves around the choice of the operator. In some fields, such as those that are marginally economic, Pemex would rightly prefer to find a partner with a lower overhead cost from whom the fields would be profitable for both the partner and Pemex.

In other fields, such as those in the Perdido Area where Pemex has had discoveries, and in which experience is lacking in relation to bringing the reservoirs into production, Pemex would rightly want an experienced partner to serve as the operator.

Farmout

In a farmout, the partner not only becomes the operator but the title interest owner of 100% of the commercial rights conferred by the lease.[1] The conveyance of title is contingent on the other party's performing an agreed-upon work program. There are diverse benefits favoring the use of this contract model, but retaining a large working interest in the lease is not one of them.

Production Sharing Agreement

While it may be true that the number of possible permutations of a PSA is infinite, for this discussion we may reduce that number to just two: 1) Standard and 2) Carried Interest with Cap.

Standard

In a standard PSA, either party may be operator. Pemex, for example, might want to auction 25% of its working interest in the super-giant Akal field. Pemex would continue to be the operator, but would have the cash from the sale to pay for investments in drilling and maintenance.

Going forward, Pemex would be responsible for 75% of the capital and operating costs, while the partner would be responsible for just 25%.

The percentage of working interest and its costs are negotiated privately. In Mexico's case, as indicated, the government wants the selection process of a PSA partner to be part of the public record.

Carried Interest with Cap

This variant of PSA is nothing more than the incoming party offering to pay the leaseholder's share of future costs up to an agreed-upon cap. The party would "carry" Pemex's costs up a specified limit, beyond which Pemex would be responsible, just as with a standard agreement.

Normally, the percentage of working interest and the amount of the spending obligation are matters privately negotiated. These two values are a function of the work program to be undertaken.

As the carrying party will be the one spending the money, it would normally be the operator of the field or block related to the agreement.

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[1] Public Policy Perspective 10036 describes the logic and mechanisms of a U.S. farmout agreement.

OBSERVATIONS

THE GOVERNMENT'S ONLY AUCTION OF INTERNATIONAL IMPORTANCE is the one scheduled for December 2016 in which deep water blocks in the government's portfolio are being offered.

In the Perdido Area, where four blocks are being offered, news of auctions of the nearby blocks of Pemex is conspicuous by its absence.

The absence of Pemex's blocks in the auction rounds will distort the economic evaluations of prospective bidders of the government's blocks, and will increase the risk of over-investment in infrastructure and sub-optimal recovery of the reservoir.

The government's dependence on royalties and other forms of monetary transfer keeps it focused on revenue at the expense of non-revenue benefits.

The delay in presenting viable paths to partnership with Pemex in its blocks in the Perdido and other areas is a policy embarrassment. It contradicts one of the broad goals of the upstream energy reform, which is to bring Pemex into association with major oil companies to the end of Pemex's gaining the experience and credibility to operate in deep water and other plays outside of Mexico.

CONCLUSIONS

THE CONTRACT MODEL most suitable for Pemex's risk-service contracts is Farmout, only that its key features of conditional conveyance, royalty, payout and conversion option do not exist in Mexico.

As for Pemex's deepwater blocks, the most suitable contract model is Carried Interest with Cap:

1) It avoids taxable events for Pemex that could occur were Pemex to offer an interest in a block as a cash sale. Pemex receives value from the investments paid for by the other party.
2) It preserves a large working interest in a block.
3) It defers the deployment of capital during the period in which the carried amount is disbursed.
4) It mitigates liability for safety or environmental incidents
5) The biddable variables are easily understood and lend themselves to a public auction.

As with the other forms of partnership, this one requires a consensus among stakeholders regarding the reasonableness of the government's demands for royalty payments.

There will be negative economic consequences for Pemex, the government and prospective bidders that will arise from further postponement of workable paths to partnership with Pemex.

Table 1

Upstream partnership options

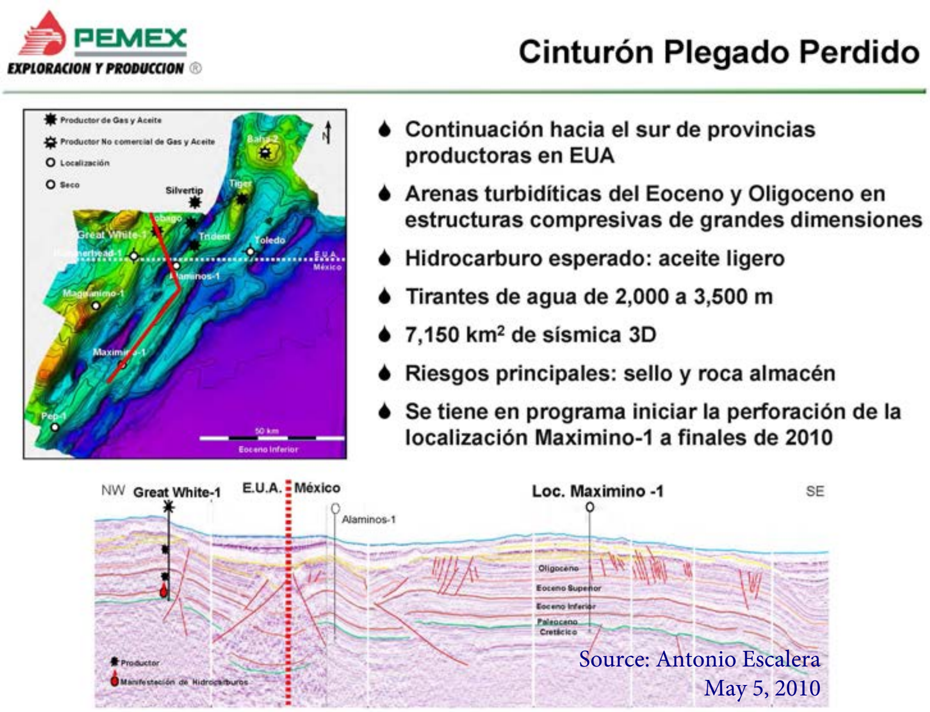
From the perspective of the original leaseholder

	Farmout	Production sharing agreement	
	Lease conveyance upon Earning Event	Auction of % working interest	
		Cash sale	**Carried interest**
Biddable variables	Work program & schedule	Cash (highest bidder)	Work program, schedule & amount of carried interest
Advantages			
Obtain financing and expertise	Good, as farmee assumes financing & operatorship	More value if partner is operator	Yes, as partner is operator
Obtain subsurface data	Good, as farmee supplies any new drilling and seismic data	Good, as partner (if operator) shares any new drilling & seismic data	Good, as partner-operator shares drilling and seismic data
Obtain royalties	Good, but delayed until after farmee cost recovery (Payout)	None	None
Avoid taxable event associated with cash sale	No taxable event, as farmee invests in the ground & in facilities	May create a taxable event	Tax liability deferred until revenue stream from production
Obtain option for working interest	Yes, after farmee Payout	n/a	n/a
Avoid capital outlays	Yes, until conversion of royalty to working interest	No, as obligation is proportionate to working interest	Yes, up to limit of the amount of cap of carried interest
Minimize liability for safety / environmental	Good. 100% of lease transferred upon Earning Event; liability only if royalty is converted	Liable in proportion to working interest	May be able to transfer liability during period of carried interest
Disadvantages			
% working interest	Working interest is lost (exchanged for royalty with option to convert)	Preserves % of working interest but with capital obligation	Same as in cash sale, but with deferred capital obligation during carry
Posting reserves*	Reserves pass to the account of the farmee	Reserves corresponding to % working interest	Reserves corresponding to % working interest
Operational control*	Transferred to farmee	Varies with JOA	Partner is the operator

*If int'l partner, subject to int'l audit rules

Data: Industry sources
Chart: Mexico Energy Intelligence® June 7-8, 2016

Report titles related to IOC Partnerships



Source: Antonio Escalera
May 5, 2010

Year	Topic	File #	Pages	Chart

2016

Mar 22, 16	**Pemex E&P organizes for Partnerships**	807	8	2

This report focuses on the on the way that Pemex' Exploration & Production (PEP) has been reorganized to give priority to partnerships with other oil companies. Table 1 displays the dozen-plus instances where farmouts are mentioned in PEP's Internal Statutes of July 3, 2015. Table 2 lists the names of executives, department heads and managers whose areas have farmout responsibilities.

2015

Dec 29, 15	**Pemex's Farmout Strategy: International Expectations**	10036	13	3

As far back as July 2014--three weeks before the promulgation of the energy reform legislation--Pemex told Reuters about its plans for farmouts, using a term that had scarcely been heard before in Mexico. During the following 15 months Pemex identified blocks that would be candidates for farmouts. Together, these blocks covered some 525,000 acres with an expected investment of some $50 billion. This report is an examination of the nature of a farmout agreement, its core concepts and terms. In a separate report, we shall examine the legal issues to be resolved before a farmout agreement can be signed.

Report titles related to IOC Partnerships

Year	Topic	File #	Pages	Chart

2008

Year	Topic	File #	Pages	Chart
May 31, 08	**Deepwater Motivations: The Logic of Partnerships** The logic of partnerships in deepwater ventures responds to the interests not only of the oil companies but also to those of society: all parties want new oil supplies and optimized value-generation. In Mexico's case, Pemex has told the government that it cannot develop the deepwater areas of the Gulf of Mexico alone. The current energy debate hinges largely on this one statement. A new window into the debate in Mexico is offered by the experience of IOCs for whom such associations are routine.	736	10	1

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