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TRION AUCTION: WHAT'S THE DEAL?

Farmout or PSC?

THE QUESTION "WHAT'S THE DEAL?" may be asked to express mild surprise at the behavior of someone: the irritated teenager who discovers that his iPhone data plan had been turned off could ask his mother, *What's the deal?* In commerce, the question refers to the precise way and timing of how something of value is transferred from one party to another. It is this sense of "deal" that Donald J. Trump uses in his book *The Art of the Deal* (1987).

The opportunity to become the first equity partner of **Petróleos Mexicanos** (Pemex) in an upstream venture raises the question: *What's the deal?* The meaning of "something of value" goes beyond cash flow: What does it mean to be the first partner of Pemex in its nearly eight decades of operation? How will the Mexican public react? How will shareholders and market analysts react? How difficult or easy will it be to collaborate with Pemex executives, technical people and members of its unionized workforce?

On August 29, 2016, the governing board of Mexico's National Hydrocarbon Commission (CNH) met in executive session to review the calendar to register for access to the data room of the Trión block. The block is the first asset to have a portion of Pemex's working interest put up for auction. The meeting was prompted by the alarming fact that only two companies had registered.

That only two companies were ready to publicly declare their interest in becoming Pemex's first strategic partner was more than an embarrassment; it was a clear sign that the marketing plans of Pemex and the government for the upstream had flaws more serious than had previously been supposed.

The commissioners voted to extend the period for registration by one week to September 5, and consideration was also given to extending the date for the submission of bids beyond December 5, 2016 (the date for bid submission for the blocks in the parallel auction known as Round 1.4).

Contents

In this report, we ask a question about the commercial nature of the Trión deal: The National Hydrocarbon Commission (CNH) refers to it as a *farmout,* which would mean that the bidder's obtaining a working interest in the Trión block would be contingent on the winner having performed specific, qualifying activities. If the deal is not that of a farmout, then the bidder's working interest is established upon the signing of the contract with CNH. Which is it?

TRION AUCTION: WHAT'S THE DEAL?

Farmout or Production Sharing Contract (PSC)?

INTRODUCTION

THE DISCUSSION IN MEXICO ABOUT PEMEX PARTNERSHIPS has been going on for a quarter-century. There was an opportunity in the early 1990s when the PRI controlled both houses of Congress, but the government felt that it needed to keep oil "off the table" of negotiation in NAFTA out of concern that the Mexican public would interpret any change as a result of pressure from the United States.

Pemex deals, 2001-13

President icente Fox was elected to office in December of 2000 as the first non-PRI president in seven decades. His popular mandate was of such magnitude that he could have forced consideration of the constitutional changes that instead would have to wait a dozen years to be taken up by the PRI.

During his term (2000-06), Pemex offered a form of risk-service contract (known, famously, as the Multiple Service Contract). The deal that was offered was a disappointment to the global oil industry, and only one American company, **Lewis Energy,** was awarded a block. The deal entailed payment to the contractor according to a schedule of activities (that is, provided that, taken together, the activities had produced natural gas sales in sufficient amounts to cover invoices for services). This around-the-barn approach to linking contractor activity to gas production was necessary because of the legal barrier represented by Article 4 of the Petroleum Law of 1958, which barred payment to contractors based on results (i.e., production).

It was rumored that Fox's National Action Party (PAN) was in favor of a constitutional change that would permit Pemex to have partners all along the hydrocarbon value chain, but that opposition in the Congress by both the Loyalist Party (PRI) and the Populist Party (PRD) could not be overcome. The Energy Reform of 2008 left in place the legal barrier to a contractor having a working interest in hydrocarbon blocks held under leases granted exclusively to Pemex.

The Pemex Governance Act of 2008 provided for a new board of directors with authority to approve new procurement rules that would correspond to the unique features of the oil industry. By 2011, Pemex was ready to issue public tenders for mature fields in Tabasco. The deal offered was that the contractor would bid a fee payable for incremental production of hydrocarbons (including oil for the first time). The deal offered was attractive only to service companies, as there was no equity in the resources of the block.

By 2013, Pemex had awarded some two dozen such contracts, but without attracting any major oil company. When Pemex offered 100% reimbursement for exploration, **Halliburton** saw an opportunity that Pemex had not foreseen: **a** shell company won a block with the lowest possible bid of US 0.01/bbl.[1]

Ironically, given its history of opposition to any constitutional changes regarding hydrocarbons, it would be the next PRI administration that would change the constitution to allow for three major changes in the oil regime:

1) The State would offer oil blocks directly, without the involvement of Pemex, and
2) Pemex could have partners in the legacy blocks that would be conveyed to it at the discretion of the government in an assignment process known as Round ero.
3) It would be CNH, not Pemex, that would choose its partners by means of a public auction in which the biddable variable(s) would be determined by the Finance Ministry.

The Pemex deal of 2014

Pemex wanted to convert (or "migrate," to use the literal translation of the law) the risk-service contracts of 2003-13 to one of the several contractual forms permitted by the hydrocarbon legislation that was promulgated on Aug. 11, 2014. These forms included license, production-sharing and profit-sharing.

There were several impediments to accomplishing this conversion/migration, the principal one of which was the requirement in the Hydrocarbon Revenue Act (Art. 34) that in any conversion the State must be guaranteed at least the same fiscal revenue stream as in the original contract. This requirement left Pemex with little room to negotiate, and the risk-service companies could see little benefit from moving to a new contractual arrangement, especially when Pemex had outstanding invoices.[2]

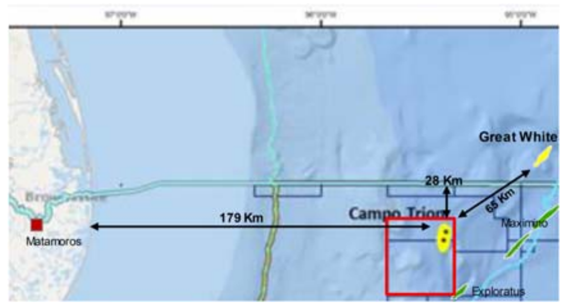
It was Pemex's plan to migrate the contracts, afterwards seek partners for blocks in frontier areas. Events would reverse this order.

1 Profits would come from the commercial margins in the prices to be charged to the shell company for services rendered by affiliated companies.

2 It was rumored that **Petrofac**, a risk-service contractor that had won two blocks in the Mature Fields auction 2011, was owed upwards of US 20 million.

As early as October 20, 2014, in a road show in Houston, Lourdes Melgar, the Deputy Secretary for Hydrocarbons, advanced the idea of synergy between Pemex and operators.

The Pemex deal of 2016



Source: Pemex

At the Offshore Technology Conference (OTC) on May 3, 2016, Dr. Melgar told the audience that Round 1.4 (for deep water blocks) would be held simultaneously with the auction of a Pemex block in deep water. Not until June 10, however, did the Pemex board request approval from the Energy Ministry for the migration of two assets in the Trión area.[3] Six additional weeks would pass before, on July 28, it was announced that the first auction of a working interest in a block formed by the unitization of two Pemex blocks would be scheduled for the same date as Round 1.4 (see map[4]).

Prospective bidders would have just one month to reach a decision about participating in the auction. They would have until August 29 to qualify for gaining access to the CNH data room for Trión and until August 31 to register for the auction.

On August 29, with only two companies having expressed interest in the Trión auction, the commissioners met to consider extending the period for registration. During that session, consideration was given to postponing the award date beyond December 5, 2016, the date scheduled for the presentation of bids for deep water Round 1.4.

The mismatch was noted between the time available for prospective bidders in Round 1.4 (7 months) and the time available to prospective bidders in the Trión auction (1 month).

Commissioners did not raise a question about the nature or legal format of what was being offered in the auction.

BACKGROUND

IN PRIOR REPORTS (See appended title list) , we have gone to considerable effort to explain, with hypothetical examples, the nature of a farmout agreement and its use in the global oil industry. The basic idea is that in order to fully exploit the petroleum potential of his lease, a leaseholder (termed a farmor), may invite other parties to develop a

[3] The two blocks were AE-0092 and 0093. There was a third, 0094, which could have been included to better dovetail with CNH Block 1.

[4] http://www.pemex.com/saladeprensa/boletines_nacionales/Documents/Mapas%20Trion.pdf

Reports related to the Trión Auction

Year	Topic	File #	Pages	Chart

2016

Year	Topic	File #	Pages	Chart
Aug 24, 16	**Trión Auction: Problematic Issues** This report draws on our critiques of the government's bidding protocols for the three auctions of Round 1 held in 2015. The report identifies risks for the several stakeholders in the Trión auction: the government, Pemex and prospective bidders. In the second part of the discussion, we offer ideas for how to improve the process of partner selection.	816	11	0
Jul 21, 16	**Parallel Auctions in Perdido** In the column "La Energía de Baker" published in MILENIO on July 19, we observed that Pemex was coming into Round 1.4 at 11:45 p.m., proposing 2 of (its 3) blocks in the Trion area for private investment. The published text omitted a paragraph of conclusions about Pemex's options going forward. This report provides a translation of the complete text.The matter is this: The legal framework does not permit a farmout (as understood outside Mexico); Pemex has no budget to develop Trion by itself; the option of a production sharing agreement with carried interest is uniquely feasible.	1000084	3	0
Jul 19, 16	**De las formas paralelas: ¿Trión y Fénix?** This column asks, skeptically, about the likelihood that the many tasks associated with a lease auction can be carried out of two blocks of Pemex in the Perdido area in time for the auction of deep water blocks in CNH Round 1.4. Ten days later, CNH published its auction schedule for Pemex's leases in the Trión areas to coincide with the date for the auction of the government's blocks (Dec. 5, 2016). The role of Lourdes Melgar in promoting synergy between Pemex and other oil companies is mentioned. Published in MILENIO "La Energía de Baker."	071916	1	

Reports on the Trión Auction

Year	Topic	File #	Pages	Chart
Jul 12, 16	**Seeking Synergy in Perdido (Update)** On June 5, Pemex's board of directors approved recommending the development of two of its blocks in the deep water Perdido Area with partners. Since then, no information has been released. In this updated report, we show that there is a 3rd Pemex block in the Trion Area (AE-94), a working interest in which should be offered to complement the acreage of Block 1. We review options for parternership models and conclude that there is insufficient time in the 2016 calendar to organize an auction for the Trion leases. For this reason, the bidding for Block 1 should be rescheduled for 2017.	809.1	13	4
Jun 13, 16	**Trión 101: Pemex proposes fast-track for deep water auction** This report draws on industry courses for an initial impression of Pemex's last-minute proposal to include the Trión block in an auction to be scheduled in parallel with Round 1.4. Three potential commercial arrangements are considered: 1) Farmout, 2) Standard Production Sharing Agreement (PSA) and 3) Carried PSA. In order to allow sufficient time for the bid round to be organized and for prospective bidders to have access to a data room, Block 1 of Round 1.4 should be rescheduled at an appropriated time in 2017.	1000083	8	2
Jun 07, 16	**Paths to Pemex Partnership: Farmout, Cash Sale and Carried Interest** This report identifies three contract models that could serve in partnerships between IOCs and Pemex in Pemex blocks: 1) Farmout, 2) Standard Production Sharing Agreement (PSA), 3) Carried Interest PSA. Table 1 provides a list of the advantages and disadvantages of each model from the perspective of the original lessor. The report calls attention to the need for an auction round of Pemex blocks in the Perdido Area to complement the blocks offered by the government in Round 1.4. A video from 2008 on Pemex's challenges in deep water areas is instructive: http://bit.ly/1WIM3Wl.	10037	6	1
Mar 22, 16	**Pemex E&P organizes for Partnerships** 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.	807	8	2
Mar 15, 16	**Outlook for Farmouts in Mexico** A Reuters news article on July 24, 2104, noted Pemex's plans for farmout agreemments; moving forward, at Pemex Investor Day in London on Oct. 6, 2016, Pemex gave details of 17 projects for a farmout. This report provides a basic description of a farmout agreement, and the then examines the terms and concepts of Mexico's hydrocarbon legislation to see how closely they match international usage. Absent from the discussion in Mexico is the eventual need of the CNH contractor for the commercial figure of farmout. Exhibit C defines and translates 18 terms in global usage in English related to farmouts.	799	42	10

Reports on the Trión Auction

Year	Topic	File #	Pages	Chart

2015

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

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