

GRANTING RIGHTS FOR SUBSOIL USE

**CHANGES FOR BETTER REGULATION
IN OIL&GAS SECTOR**

This policy brief is prepared within the framework of the Project “Improving the resource governance in the extractive sector by taking part in the implementation of the action plan for Concept for Ukraine’s Gas Production Industry Development Until 2020” supported by the Natural Resource Governance Institute (NRGI). The Project is implemented by DiXi Group think-tank. Any views or statements expressed in this document do not necessarily reflect those of the Natural Resource Governance Institute.

The Project is mainly aimed at providing information support for amending the extractive industries legislation through increasing the Parliament’s awareness on importance of more comprehensive transparency in the extractives based on findings of the 2017 RGI Index, as well as at facilitating of further reforming of the extractive sector of Ukraine.

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Recommendations

This note analyzes the regulations and procedures for granting the rights to use subsoil in Ukraine, Romania and Mexico. Both international cases offer interesting practices which could be applied in Ukraine for attracting investment and holding transparent tenders for oil and gas fields.

The analysis into regulation in the mentioned countries results in the following recommendations for Ukraine:

- ▶ **Electronic licensing auctions should become a permanent mechanism for granting special permits to use subsoil.** This means a transition from their temporary or experimental application to permanent practices. The conduct of licensing rounds exclusively via electronic bidding requires making the Temporary Procedure, adopted by the CoM (Cabinet of Ministers) Resolution No.848 of October 17, 2018, a permanent one, with cancelling the CoM Resolution No.594 and amending the CoM Resolution No.615 of May 30, 2011. This step will ensure equal and transparent conditions for access to the subsoil for everyone interested.
- ▶ **Special or exclusive conditions for obtaining special permits out of competitive procedures (license auctions or PSA tenders) should be eliminated.** In particular, selective amendments to the Subsoil Code and the Procedure for Granting Special Permits are required to guarantee an integrated permit for oil&gas operations. I.e., types of subsoil use shall include geological exploration, pilot development and production. Setting such a practice will eliminate corruption risks both at the national and local levels, as changing the type of subsoil use requires passing of non-transparent procedures. For the integrated special permit, it is also necessary to clearly identify operations for mandatory environmental impact assessment under criteria defined by Directive 2011/92/EC.
- ▶ **Consider introduction of bidding for subsoil use as competitive procedure which takes into account qualitative criteria.** Bidding should take into account other criteria in applications, besides the price. This means, following the model of Romania, clear and measurable indicators to be assessed in the participants' bids. A package of documents, e.g., may include a detailed work program and serve as a proof of financial or other resources for the program implementation. The set of evaluation criteria, accordingly, should mirror the requirements set.

This approach will make it possible to include qualitative criteria for selecting a winner, to eliminate participation in biddings of fly-by-night companies without resources.

▶ **Provide the opportunity to select a license auction winner, even in the case with one bid submitted.**

This mechanism is already in place for PSA tenders. In particular, according to the PSA Law, the tender takes place even when a bid has been submitted by one bidder, “given all conditions of the tender are met”. The extension of this practice to cover license auctions requires targeted amendments to the relevant procedure. However, this small change will offer the chance to avoid simulated competition, where a partner “plays out a fake competition” for the field. In addition, the government will be able to attract investors to develop fields which look unattractive for many players for various reasons, if a single bid is submitted.

▶ **Considering PSAs as a special regime for fields with complex geology or large-scale projects with application of new technologies, not as alternative to license auctions.**

At the moment, fields can be put either to a license auction or to PSA tender. At the same time, the definition of conditions for conducting of PSA tenders is too broad (e.g. the need of “advanced exploration of the field” or “creation of new jobs”). This allows nominating any oil&gas field to PSA tender and, in the end, getting much better conditions than those under the regular

licensing regime. Amendments to the PSA Law (Article 6) or bylaws should detail the conditions for the fields for PSAs with specific measurable indicators or minimal requirements.

▶ **Launch special procedures and evaluation criteria for oil&gas and mining projects.**

Due to specific features of this activity, production of hydrocarbons, as a rule, is regulated by special laws and even by dedicated authorities. This approach is applied in many countries, including Romania and Mexico. In Ukraine, this would require systemic changes to the legislation - via amendments to the Oil and Gas Law and the Mining Law, and/or the codification of these provisions in the new version of the Subsoil Code. These amendments will, inter alia, allow the launch of modern regulatory practices - in particular, introduction of a single permitting authority under “single window” or “umbrella” principle, simplifying the permitting and monitoring procedures.

▶ **Clearly divide licensing and research functions of the State Service for Geology and Mineral Resources of Ukraine (GeoSurvey), to remove non-relevant functions.**

At the moment, GeoSurvey has the functions of both a licensing authority and a traditional geological agency that means a potential conflict of interest. In most countries, these functions are unbundled, and the cases below are no exception. For instance, SGM in Mexico and IGR in Romania are in charge of the management of geological information databases, research

activities, providing the industry with data and research. While licensing, control over subsoil use and public policy implementation is vested in the National Agency for Mineral Resources (NAMR) in Romania, or the integrated authority for hydrocarbons (CNH) in Mexico.

Separation of functions on the level of directorates and departments may become the first stage in reforming GeoSurvey. Units performing unnecessary functions – i.e. those which can and should be executed by market players – should be dissolved or reorganized.

The next stage – the allocation of regulatory and licensing functions concerning subsoil use to a new authority – will require a political decision. This means amending certain laws and regulations in order to transfer all functions related to exploration and production to the new body, as well as to ensure its independence and capacity. Institutional changes can be intended on providing a comprehensive support to investors in the oil&gas sector based on “umbrella” principle.

- ▶ **Introduce the possibility to transfer the exploration and production rights.** So far, the only mechanisms for obtaining the rights (or a share) to use subsoil are the purchase of the company holding a special permit or getting shares in its authorized capital, or – for PSAs only – the transfer of rights and obligations to third party (upon consent of the government and given certain conditions are met).

Amendments on full or partial transfer of rights should be made to the Subsoil Code (Article 16), and a regulatory framework should be developed. On the level of regulations, it is necessary to define procedures of authorization by the government bodies and conditions on which the rights are transferred. Following the Mexico model, it is worth considering such mechanisms as farm-out agreements and others. These changes will promote M&A activity in the market and encourage investments, inter alia, in “sleeping licenses”.

- ▶ **Plan bidding procedures, organize rounds of selling special permits.** The GeoSurvey practice of preparing and simultaneous launching of electronic auctions for a group of fields should become a standard practice. 1 to 3 rounds shall be held each year, and the fields should be selected in a way to raise interest of both large transnational investors and medium-sized companies. This approach needs to be refined at the level of the GeoSurvey practice which can announce prospective fields and study feedback from investors. The schedule of licensing rounds shall be coordinated with the launch of PSA tenders – to this end, interagency cooperation is required.

In addition, investors should have enough time to study the fields and prepare high-quality applications. This may require amendments to relevant procedures for granting of special permits and the PSA Law in order to review the period between the tender announcement and the

deadline for submission of bids.

The purpose of grouping the fields in rounds is to attract as many applicants as possible, while a longer period for preparation is intended on improving the quality

of applications. It also provides the possibility to ensure maximum openness - to organize road shows, investment conferences, to communicate information to potential applicants by other channels.

Introduction

The situation with granting rights to use subsoil is quite challenging in Ukraine. On the one hand, there is a problem of long-lasting failure to conduct license auctions for special permits for the development of oil&gas fields. According to BRDO, in 2013-2017, 23 special permits were sold via license auctions, with a total of 146 special permits issued – i.e. 84% of the rights to use subsoil were granted out of competitive and public procedures¹. The reason is a still long list of the grounds for issuing special permits without an auction. In 2018, GeoSurvey conducted a license auction – first time in two years – to sell the rights for oil&gas fields; however, the two fields auctioned did not radically affect the situation.

In addition to limiting investor's access to greenfield projects, there is a rather limited toolkit for attracting capital in the development of brownfield projects. Historically, joint activity agreements between state-owned companies (in

particular, Ukrzavvydobuvannya²) and private partners have become a cover for violations and revenue misappropriation schemes – although there were several success cases of cooperation with investors³. In addition, due to the imperfect regulations and insufficient transparency of extractive companies, the problem of so-called “sleeping licenses” remains in place in Ukraine – fields awarded with no development activity. Against the background of low M&A activity, including sales and purchases of companies in the sector, such fields are not being developed for a long time and remain inaccessible to the investors willing to obtain relevant rights.

At the same time, in recent years, the government, the parliament and stakeholders have put lots of efforts in addressing these issues. A large number of the tasks, as set in the Action Plan implementing the Concept of the Gas Industry Development in Ukraine

1 https://cdn.regulation.gov.ua/62/df/f1/89/regulation.gov.ua_Регулювання%20доступу%20до%20нафтогазоносних%20надр_07.12.18_web.pdf

2 <http://ugv.com.ua/uk/page/ukrgazvidobuvanna-rozirvalo-u-stokgolmskomu-arbitrazi-dogovir-pro-spilnu-dialnist-z-karpatigaz>

3 <https://www.shell.ua/medianovini-shell/novini-2015/shell-ta-ukrgazvidobuvannya-zaverшили-poshukovo-rozvidувальni-roboti.html>

(CoM Order No. 1079-r of December 28, 2016⁴), as well as in its updated version of October 2018⁵, have been completed. In particular, the oil&gas field permitting system has been simplified in general, the procedures for granting special permits and conducting of license auctions have been amended to provide more open and equal access to the rights for subsoil use, and to liberalize access to geological information. Also, the launch of the electronic license auctions for sale of special permits and the initiation of PSA tenders will increase the number of special permits issued via transparent competitive procedures.

On the other hand, the government and the parliament face the task of further improving the procedures for granting rights to use oil&gas subsoil. These include, in particular, the adoption of a new Subsoil Code and/or improvements to the Oil and Gas Law, a clearer definition of the calculation of special permit fee, the launch of an electronic application system, the reform of the State Service of Geology and Mineral Resources, and the mandatory project-level reporting on payments to government.

DiXi Group experts have already submitted their proposals based on the best global practices in the Roadmap for Resource Governance Policy Reform⁶. One of the proposals is to establish a single licensing authority and modeling a document for all rights as may be necessary for subsoil use under the “single window” principle, as well as to carry out a structural reform of GeoSurvey with a view to separate its authorization

(licensing) and research functions.

This analytical note deals with the lessons learnt in the granting of rights to use subsoil. The applicable procedures in Ukraine are compared with those in Romania and Mexico. The two cases were selected by the following criteria: experience of attracting foreign investors, disclosure of information on licensing rounds, geography (legal systems), positions in the Resource Governance Index (RGI).

The experts of DiXi Group believe that certain mechanisms may be applied in Ukraine to ensure sustainable use of natural resources and to attract companies with the best standards of operations, reporting, environmental protection, health and safety.

4 <https://zakon.rada.gov.ua/laws/show/1079-2016-%D1%80>

5 <https://zakon.rada.gov.ua/laws/show/842-2018-%D1%80>

6 http://dixigroup.org/storage/files/2017-11-16/road_map_web_1.pdf

Regulation in Ukraine

The procedure for obtaining special permits in Ukraine, as compared to that in other resource-rich countries, is quite complex and long-lasting. In 2017, Ukraine's oil&gas sector received only 49 out of 100 points in the Resource Governance Index (RGI) and ranked 44th among 89 measurements⁷. At the same time, due to overregulation, these processes were often accompanied by scandals and contain potential corruption risks. According to BRDO assessment, 12 out of 83 regulatory acts have the attributes of being unlawful and need to be cancelled or modified, another 24 are not fully consistent with the legislation and have to be updated⁸.

In this regard, the reform of the State Service for Geology and Mineral Resources (GeoSurvey), which is responsible for issuing special permits for exploration and production, is an important element in the extractive sector reform. According to EuroGeoSurveys assessment, 80% of the GeoSurvey's functions are "unnecessary" and can be performed by private sector⁹.

At the same time, in October 2018, the government took a decision¹⁰ to introduce electronic license auctions for special permits to use subsoil. The idea was to enable delivery of high-quality and fast services to potential subsoil users applying to GeoSurvey for special permits. Regardless of their location, companies, on a license auction day, will be able to participate in an online e-license auction. The electronic bidding system will operate in the real-time mode, so that anyone will be able to observe the process.

It should be noted that changes to the regulations are introduced at the level of secondary legislation, since the Subsoil Code of 1994¹¹, despite numerous amendments, has not been fundamentally updated yet. The similar situation is with the Oil and Gas Law of 2001¹². Instead, the CoM Resolution May 30, 2011, No. 615¹³ approving the Procedure for granting special permits to use subsoil is a key document. Another document regulating the license auction procedure is the CoM Resolution of May 30, 2011, No. 594¹⁴. The Production Sharing Agreements Law¹⁵

⁷ http://dixigroup.org/storage/files/2017-07-15/rgi_ukr_web-1.pdf

⁸ Green Book "Regulation of access to oil&gas subsoil"

⁹ http://geoinf.kiev.ua/wp/wp-content/uploads/2016/05/SGSSU-Assessment_A4_EN.pdf

¹⁰ <https://www.kmu.gov.ua/ua/npas/pro-realizaciyu-eksperymentalnogo-proektu-iz-789>

¹¹ <https://zakon.rada.gov.ua/laws/show/132/94-%D0%B2%D1%80>

¹² <https://zakon.rada.gov.ua/laws/show/2665-14>

¹³ <https://zakon.rada.gov.ua/laws/show/615-2011-%D0%BF>

¹⁴ <https://zakon.rada.gov.ua/laws/show/594-2011-%D0%BF>

¹⁵ <https://zakon.rada.gov.ua/laws/show/1039-14>

sets an absolutely different procedure, where a special permit is granted on the basis of the tender results and the PSA concluded.

Special permits, inter alia, are granted for the following types of subsoil use:

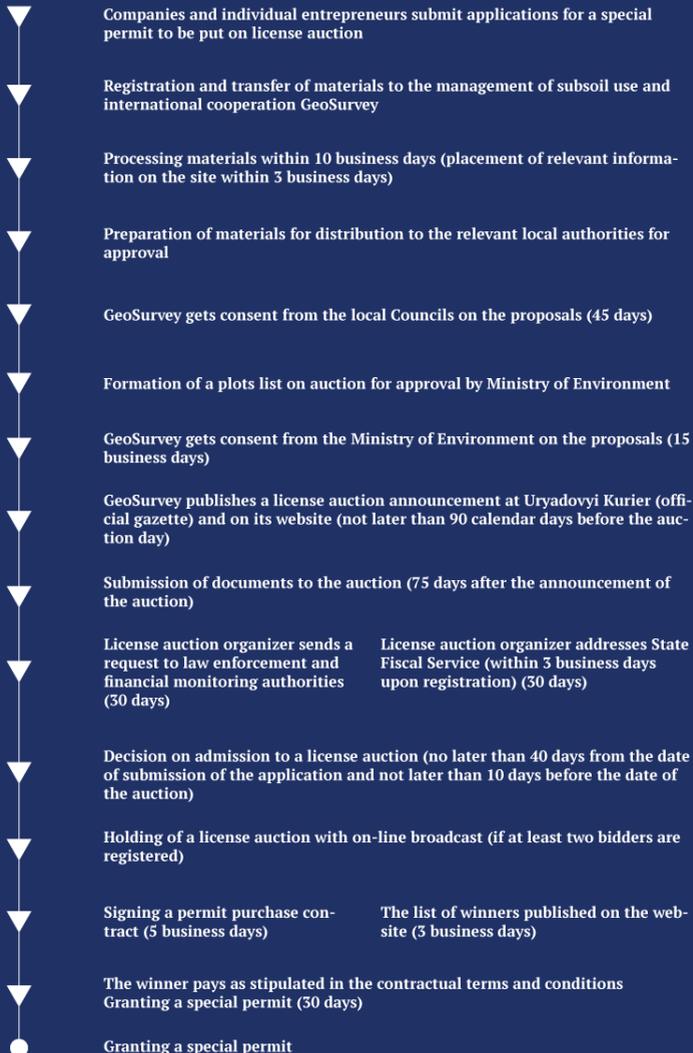
- ▶ geological exploration;
- ▶ geological exploration including pilot development;
- ▶ production;
- ▶ separately for oil&gas subsoil – geological exploration including pilot development with further production.

A permit is being issued for a specific period for each type of subsoil use within the boundaries of a specific field, specifically:

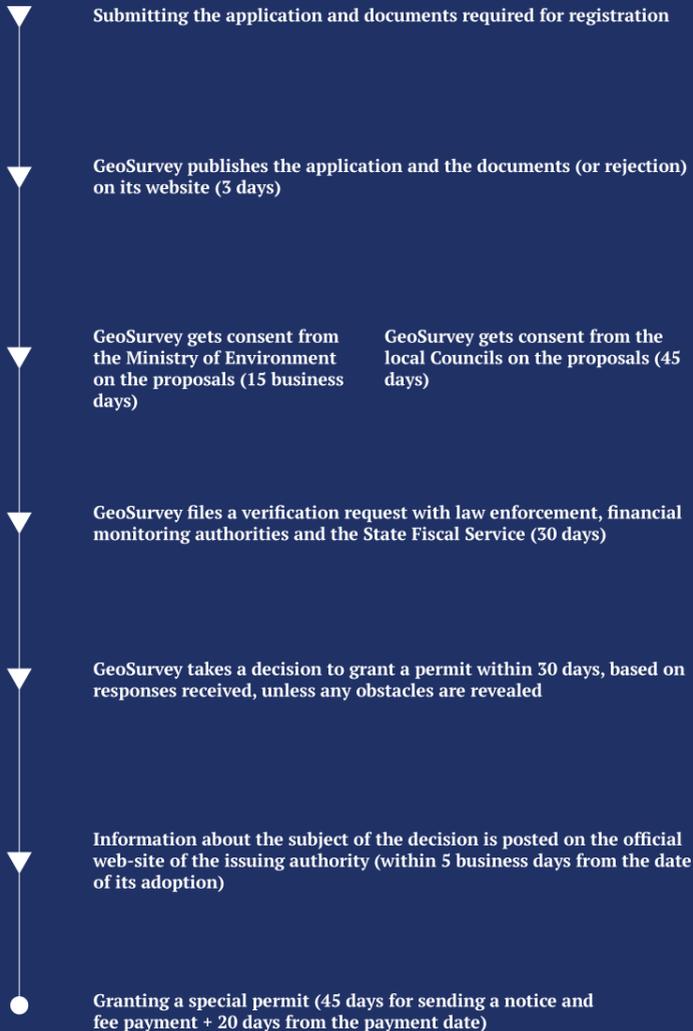
- ▶ for 5 years – for geological exploration including pilot development (10 years for offshore oil&gas fields);
- ▶ for 20 years – for extraction (30 years for offshore oil&gas fields);
- ▶ for 20 years – for geological exploration and production for oil&gas fields (30 years for offshore including pilot development with further production)¹⁶.

¹⁶ Geological exploration period may not be longer than 10 years.

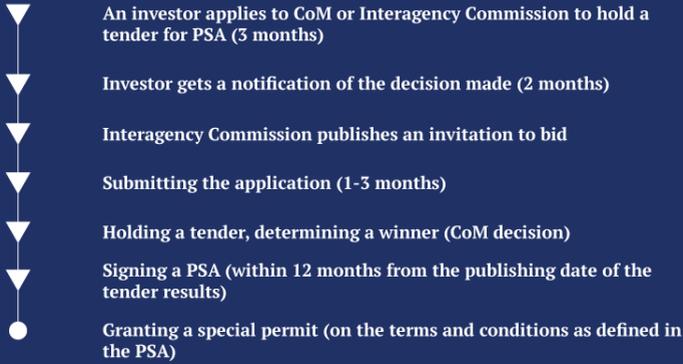
License auction



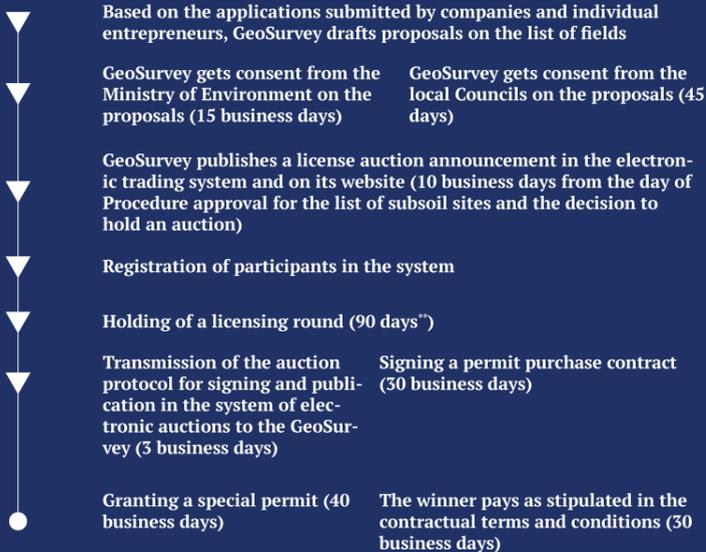
Without a license auction



PSA (tender)^{*}



Electronic auction



^{*} PSA may be concluded without a tender, if a field contains insignificant resources or a subsoil user already holds a special permit (so called "conversion" of a regular special permit into PSA).

^{**} Period for oil, natural gas and condensate; 50 days for other mineral resources.

Regulation in Romania

The development of mineral resources in Romania is governed by two laws: the Mining Act¹⁷ and the Hydrocarbons Act¹⁸. The first one is mainly applied to the mining industry and covers the extraction of metal ores, lignite and coal, salt, mineral waters and other non-metallic minerals. The second law regulates the extraction of hydrocarbons, namely oil, gas condensate and natural gas. Both acts determine that all resources in the territory of Romania and in the country's Black Sea offshore are state-owned, and any legal entity may get the exploration rights in exchange for the payment of royalties.

Romanian legislation stipulates that the National Agency for Mineral Resources (NAMR) is a regulator for the upstream sector as a whole. In fact, this body has the functions (1) to define the terms of agreements on hydrocarbons production and sign them on behalf of the state, (2) to regulate all operations related to hydrocarbons exploration and production, (3) to oversee and control relevant activities, (4) to maintain geological information database, and so on. NAMR also is responsible for the functions of regulating the operations of underground hydrocarbons' storage facilities and of the pipelines in oil&gas production industry.

17 http://www.namr.ro/wp-content/uploads/2018/04/LM85_2003modif2016.pdf

18 <http://www.namr.ro/wp-content/uploads/2014/01/LP2382004.pdf>

For the purpose of oil&gas operations, namely exploration and production, a company enters into agreement and obtains a field under concession for up to 30 years, and a relevant agreement can be extended for another 15 years subject to agreement of the operator company and NAMR. All details of the deal are agreed between the company and NAMR, and the government of Romania then approves the agreement.

The agreement is concluded in Romanian in writing and does not necessarily include the entire list of potential oil&gas operations. NAMR issues a permit for actual commencement of operations in writing, once the company receives all necessary permits and approvals required by Romanian legislation.

To commence production, a company has to get an environmental permit from the National Environment Protection Agency. The period for granting this permit which applies for both exploration and production is more than five months. If the site is located in a river bed or in the area of cultural value (cultural

heritage site), a permit is required from Romanian Waters, a national company, or the Ministry of Culture, respectively.

The holder of a license for oil&gas operations also may sell its right in full or in part to other company only upon NAMR prior written consent. At the same time, the Hydrocarbons Act reserves the right for NAMR to terminate the concession in some cases. Specifically, if (1) the company does not perform oil&gas operations during 60 days without regulator's consent; (2) the company fails to pay royalty during 6 months following the date when a relevant payment is due; (3) an environmental permit has been withdrawn; (4) the company has violated conditions of the concession agreement, has submitted false information about its business performance, etc.

The agreement for oil&gas operations can be concluded exclusively with the winner of the open bidding for a specific field. The bidding process is described in detail in the methodological explanations¹⁹ to the Hydrocarbons Act. It conditionally consists of three stages: (1) initiation of the concession; (2) preparation for the bidding; and (3) holding of the bidding and winner selection. Both Romanian domestic and foreign companies may apply.

The first stage

The procedure starts with initiation of the bidding for concession of oil&gas fields. NAMR, which is responsible for preparing the list of fields, or an investor may initiate a bidding for a certain field. In the latter case, the company applies to the National Geological Fund (FGN)²⁰ for access to information on resources and reserves in a particular site, pays a fee for the use of information and signs an agreement on non-disclosure of the obtained data. FGN, if all requirements are met, provides information to the applicant within 10 days.

Using the information received from FGN, the company can prepare a request to NAMR seeking to initiate bidding for the requested field. From the moment of receipt of such request, the regulator within 45 days checks and determines the boundaries of the field, its coordinates and decides on the bidding. The decision shall be communicated to the initiator within a 5-day period.

As a result, the list of oil&gas concession fields put to public bidding is approved within 15 days by order of the NAMR chair and published in the official bulletin of Romania and in the Official Journal of the EU. For each field, the geographical coordinates and the period for submission of bids must be detailed. According to the Law, this period should be not less than 30 days and not more than 270 days. Also, if necessary, information on possible soft terms and other information is indicated.

¹⁹ <http://www.namr.ro/wp-content/uploads/2013/02/hot20752004.pdf>

²⁰ Institute of Geology of Romania (IGR), a national geology service, is responsible for administering of FGN

The second stage

The procedure continues with the preparation to an open bidding for oil&gas fields. At this stage, NAMR develops and approves the bidding procedure, in particular, every round of the bidding. Also, within 30-to-90 days from the date of NAMR chair order publication, an expanded list of information about the fields is prepared. This information is also subject to approval by the order of the NAMR chairperson and is published in the official bulletin of Romania.

At this stage, applications from companies willing to participate in an open bidding are invited. The companies get registered and sign non-disclosure agreements. Also, bidders have the opportunity to read the basic text of the agreement and, for an additional fee, to get access to additional data about the lot.

The third stage

The process completes with holding of the bidding and selecting a winner. Registered and admitted bidders study all information about lots and submit their bids. 3 to 6 months may be provided for this purpose depending on the NAMR decision. A bidder may submit only one bid for one lot; however, a company may submit bids for several lots.

The procedure of bid submission requires that companies draft them in Romanian and submit them in writing in 2 copies (the second one is for archives). At the same time, the company itself bears responsibility for completeness of information as well as for compliance with the deadlines for bid submission. The bid format is a defined list of documents to be enclosed into two envelopes.

The “inner” envelope should contain a proposed program of oil&gas operations, its estimated cost, environmental impact assessment of potential implementation of the work program and the program for environment remediation. Also, this envelope should contain bidder’s details: name and address.

The “outer” envelope should contain the following documents, besides the “inner” envelope:

- ▶ statement of participation indicating the name of field put to bidding, its position in the list of lots and geographic coordinates in accordance with the approved order of NAMR chair (at the first stage); the statement to be signed by the applicant top manager and sealed;
- ▶ company’s details, specifically (a) name, (b) registered address, (c) registration or fiscal code, (d) capital size, (e) information about shareholders or associated partners, (f) name, position, contact details of a person to participate in the bidding;
- ▶ copy of bidder’s registration certificate (issued at the second stage);
- ▶ certificate issued by the National Trade Register Office²¹;
- ▶ list of FGN data underlying the bid as well as confirmation of the lawful ownership of the data: an invoice issued by FGN and a relevant payment receipt;
- ▶ letter of recommendation issued by

²¹ <https://www.onrc.ro/index.php/en/>

the bank, which is to indicate the information about the company's liquidity, its financial solvency;

- ▶ other documents issued by state authorities, which confirm the company's integrity: in particular, information about insurance of employees (medical, social, etc.), information about tax compliance, etc.; for foreign companies which have not been doing business in Romania - the latest annual report.

NAMR duly registers the submitted bids – the envelopes with the listed documents in duplicate – and keeps them until the moment of public opening. If the envelope is damaged or the submission deadlines are not complied with, the documentation will not be registered. Also, when considering bids upon opening of an “outer” envelope, if the submitted documents lack any information, the bid is automatically rejected, without further consideration of the documents enclosed in the “inner” envelope.

Once the submission deadline expires, the commission approved by the NAMR chair, publicly, in the presence of applicants' representatives, opens the envelopes and verifies compliance with the requirements.

The relevant minutes are transmitted to the assessment commission, which determines the winners for each lot. Article 49 of the methodological explanations to the Hydrocarbons Act clearly defines the list of indicators to be assessed and the possible number of points. 6 indicators are used to assess bids for exploration (in total, from 70 to 120 points), 7 indicators - for extraction (in general, from 70 to 130 points). If two or more companies have received the highest final score, the preference is given to the bidder with the higher score for the proposed work program. Also, the assessment commission continues to work with the winner to finalize the wording of agreement for oil&gas operations.

Romania

stages of oil&gas fields concession

Initiation of concession

Company initiates

NAMR initiates

Geological data purchase from FGN (10 days from the moment of payment)

Proposal submitted to NAMR

NAMR considers the proposal, makes decision (up to 45 days)

NAMR informs the company (5 days after the decision)

NAMR forms a list of oil&gas fields to public bidding

Publication of the order in the official bulletin (up to 15 days after the list is formed)

Applications submission and registration (30 to 270 days)

NAMR develops and approves the bidding procedure

NAMR prepares expanded information about the fields (30 to 90 days after the publication order with the list of fields)

Applicants submit written bids for each lot (3 to 6 months)

Assessment commission publicly opens the submitted bids

Assessment commission assesses the bids and informs participants on the results (15 to 30 days)

Assessment commission agrees the concession terms with the winners

The government adopts the concession agreement. Term of concession is up to 30 years and can be extended for another 15 years

Regulation in Mexico

The specific feature of Mexico is the fact that until recently, the rights to develop oil&gas had been provided exclusively to PEMEX, a state-owned company. The energy sector reform of 2013-2014 destroyed this monopoly: despite the fact that the subsoil continues to be the state-owned property, private companies, including foreign investors, may also develop and extract mineral resources.

Upon reorganization of PEMEX, a state-owned oil&gas and petrochemical company, greater responsibility was allocated to the National Hydrocarbons Commission (CNH), which is now responsible for regulation, monitoring and evaluation of all hydrocarbons exploration and production activities, as well as to the Energy Regulatory Commission (CRE), and also resulted in the establishment of a new regulator - Industrial Safety and Environmental Protection Agency (ACEA), which is responsible for issuing environmental permits prior to starting exploration, drilling and production.

In the course of the reform, Mexico amended the Constitution, adopted 21 legal acts and 22 regulations (rules, guidelines)²², 10 out of which are directly related to the production, transportation and marketing activities in the oil&gas industry. The main ones are the

Hydrocarbons Act²³, the Hydrocarbons Revenue Act, the special laws on PEMEX and ACEA etc.

While the Hydrocarbons Act regulates key issues of exploration and production of these energy sources, the Hydrocarbons Revenue Act regulates all compensations, taxes and royalties applicable to each type of agreements, as well as legal aspects of their management and supervision.

In Mexico, the following types of agreements are currently in use to grant the right to use subsoil:

- ▶ profit sharing agreements (service contracts where the profits from the sale of hydrocarbons are distributed between the government and the contractor, while the ownership of the products remains with the government);
- ▶ production sharing agreements (the operator gets a share of the production, but assumes all the costs and risks related to the activity);
- ▶ license agreements (hydrocarbons owned by the government until they are extracted, upon extraction they can be sold.

²² <https://uk.practicalallaw.thomsonreuters.com/Document/1d4af1a831cb511e38578f7ccc38dcbce/View/FullText.html>

²³ <https://www.tklaw.com/files/Publication/5f93e40d-fc4d-445c-b7f9-7dc1cc20b56e/Presentation/PublicationAttachment/9b630df7-5e9e-4e9c-a2f6-80af30e552ff/Mexico-Hydrocarbons-Law-English-Translation.pdf>

As of December 2018, 112 agreements were concluded, including 77 of regular licenses and 35 production sharing agreements²⁴. Contracts, including all the terms, are open to public and published on the CNH website.

The terms and conditions in hydrocarbons exploration and extraction contract (CEE) are non-negotiable, i.e. the companies that have won relevant rights must sign them and accept the terms defined. In addition, the contract provides for all conditions of the cost reimbursement mechanism, which may vary depending on the agreement type (analogue of the concept of “compensatory production” in the Ukrainian legislation on PSA). Contracts are published by CNH after the results of the tender are announced.

Interested companies have the necessary information on the terms of the agreement before starting participation in the bidding procedure. Approximately a month before bids are invited, the government publishes minimum values for the government’s consideration (applicable to production sharing agreements) or a minimum value of additional royalty to be paid to the government of Mexico (applicable to license agreements). Based on these values, inter alia, the bidding starts. The Ministry of Economy also sets minimum requirements to the “national content” in the exploration and extraction activities.

²⁴ https://portal.cnih.cnh.gob.mx/downloads/en_US/estadisticas/Contracts%20summary.pdf

The government, via CNH, can conclude exploration and extraction contracts (CEE) with PEMEX, state-owned oil&gas company, other state-owned extractive companies, or private legal entities. In the process of technical documentation drafting for a specific bidding (round), the Ministry of Energy of Mexico defines technical and financial requirements, requirements for the experience that the bidders must meet.

Rules on bidding and concluding of agreements must contain technical aspects and economic requirements in accordance with the fiscal conditions set for each individual field, determine the type of agreement, prequalification criteria and periods, the mechanism for determining the winner and, where appropriate, the procedure for amending contract terms and conditions. These guidelines, which are provided to the interested parties, are subject to preliminary opinion of the Federal Competition Commission to be issued within 30 days from the date of a relevant request.

For the purpose of participating in bidding, companies can unite in consortia or partnerships in order to maximize their productivity and profitability, including sharing of costs, investments, risks, revenue, and other aspects of business.

The bidding process begins with the publication of the announcement in the Federal Official Bulletin. The period between the date of bid announcement and the submission deadline should be minimum 90 days. Bids should be submitted in closed envelopes, which are opened at public meetings, and the bidding results must be published in the Federal Official Bulletin.

Bidding process may include the following stages:

- ▶ Publishing terms and conditions
- ▶ Access to information
- ▶ Registration of bidders
- ▶ Explanation of the licensing round conditions
- ▶ Field visits
- ▶ Prequalification
- ▶ Preparation of bids
- ▶ Awarding of contracts
- ▶ Performance of contracts

The National Hydrocarbons Commission does not consider the bids from the legal entities that have been disqualified by a competent authority, have history of uncorrected violations under previous agreements, engage third parties to evade the requirements of the Hydrocarbons Act, or submitted false information. CNH may also cancel the results of the bidding and void an exploration and extraction contract (CEE) if the information submitted by the bidder is proven to have mistakes.

Contracts may be concluded without tender, directly by mining concession holders, but solely for exploration and production of coalbed methane in the same region where coal mining takes place. CNH concludes the relevant contract, provided that the operator demonstrates economic solvency, as well as technical, administrative and financial capacity to explore and produce coalbed methane.

The term of a license agreement is 35 years and may be extended twice for a period of 5 or 10 years, but the prolongation is subject to CNH approval. For production sharing agreements, the effective period is 30 years and can be extended twice for a period of 5 years.

One of the specific features of the regulatory regime in Mexico is the special conditions for PEMEX, as its historical licenses can be converted into new exploration and extraction contracts (CEEs) or into contracts with the engagement of partner(s). The first scheme, so-called “migration”²⁵, involves changing the work program and fiscal conditions for a specific project. The second mechanism, so-called “farm-out”, supposes engaging partner(s) via open bidding held by CNH (except for the service contracts concluded by PEMEX before the reform, which does not require bidding)²⁶.

In both cases, PEMEX submits an application, either alone or with partners, to the Ministry of Energy, and the latter, together with CNH, approves the work program; the Ministry of Finance sets the fiscal regime for the project after “migration”. In addition to the work program, PEMEX and partner(s) draft a joint activity agreement defining the shares of participation and/or investment, mandatory royalty and other payments to PEMEX, other key parameters.

²⁵ <http://www.primerus.com/business-law-articles/migration-of-contracts-for-the-production-of-hydrocarbons-and-financed-public-works-contracts-11192014.htm>

²⁶ <http://www.mondaq.com/mexico/x/592442/Oil+Gas+Electricity/EP+Contract+Migration+in+Mexico>

As of the end of 2018, 5 migrations (1 license agreement, 4 production sharing agreements) and 3 farm-outs have been concluded. In general, Mexico does not demonstrate intensive activities as to changing the conditions for the development of projects or farm-out agreements for PEMEX historical licenses. However, in general, these mechanisms deserve attention as an opportunity to attract additional investments to state-owned companies. Specifically, classical farm-out agreements provide for transfer by the owner (farmor) of the rights to use

subsoil in exchange for specific services from other company (farmee)²⁷. Typically, these services include well drilling and completion, with the majority shareholder (farmor) enjoying the priority right for royalties from extraction, and once all costs of the partner (farmee) are reimbursed, all revenues are distributed according to the shares in the project. Farm-out agreements on transfer of the share in a project are reported to be second most popular type of contracts in the global oil&gas industry, with the lease agreements being the first one²⁸.

27 <https://www.glossary.oilfield.slb.com/en/Terms/f/farmout.aspx>

28 <https://oilandgaslawdigest.com/primers-insights/farmout-agreements-basics-negotiations-motivations/>

Mexico

stages of licenses granting



