A new Pemex legal framework

Santiago Sepulveda and Vanessa Gimenez of Creel García-Cuéllar Aiza y Enríquez look at the risks involved in developing and financing energy infrastructure projects under the new Pemex Law

In response to the heavy dependence of the Mexican federal government on revenues from Mexican state-owned oil company, Petróleos Mexicanos (Pemex), and to a recent decrease in oil and gas production that can be mainly attributed to limited long-term investments on production infrastructure, Pemex's legal framework has been significantly restructured within the last two years. The main statutes deriving from the reforms implemented are (i) the Pemex Law (enacted in 2008); (ii) the Regulations to the Pemex Law (enacted in 2009); and (iii) the Pemex Contracting Rules (enacted in January 2010).

The new legal framework strengthens Pemex through (i) a regulatory regime that grants significant discretion on operational matters; (ii) well-structured corporate governance that facilitates the decision-making process; (iii) greater autonomy in financing and budgeting areas; and (iv) a new Pemex-specific contracting regime for the procurement of goods and services.

Although the reforms still do not allow any direct participation of private contractors in oil and gas exploration, drilling and extraction activities, it is expected that Pemex will make large investments in those areas that will allow it to increase production, mainly in state-of-the art exploration and drilling technologies, including deep-water production. In these cases it is likely that Pemex will acquire or lease the necessary assets, and the contractors or suppliers will receive a consideration in market terms either at delivery or through periodic payments.

Downstream activities such as oil and gas processing and refining (as well as ancillary processes) will probably be developed by Pemex through contractors in a procurement structure that will likely allow the contractor or supplier to implement project finance structures anchored on the contractual payment stream from Pemex. The assets themselves would be owned by Pemex once delivered for operation, unless the contracting is under a long-term services contract where the supplier owns the asset and provides the relevant service to Pemex.

Under the new legal framework, Pemex is responsible for preparing and implementing its own budget without supervision from the Ministry of the Treasury or any other entity of the Federal Government, as was required in the past. However, the annual financing plan is subject to an annual cap determined by the Mexican Congress. Also, Pemex is allowed to contract debt, so long as it does not exceed its payment capacity. Subject to such restrictions, Pemex has enough budget flexibility to assume long-term obligations covering multi-annual budgets, such as those required under long-term projects to be contracted with third-parties and structured under a project finance scheme.

Moreover, Pemex's newly empowered board of directors has authority to prepare multi-annual budgets that consider reinvesting in infrastructure certain amounts of income exceeding the annual budgets. It is anticipated that, initially, all of these amounts will be used to finance infrastructure projects aimed at improving oil and gas production and processing.

Although the reforms allow Pemex greater discretionary authority to incur corporate debt to finance its operations, it is expected that Pemex will continue to obtain financing in terms similar to the recent past through: bond placements in the international and local markets; the cash flow it generates; diverse loans from governmental development banks, export credit agencies, commercial banks and international financing agencies; and the incurrence of corporate debt in each case, as allowed by the new tax and budgetary regime. It is also expected that these financings will be structured directly through Pemex or though any of its various financing vehicles (both in Mexico and offshore).

Nevertheless, many of projects will require that portions or their entirety be contracted out to third parties under the revised procurement regime through tender offers where the works or services contracted will likely be undertaken by private contractors and could be structured on a project finance basis.

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Prior to the enactment of the new legal framework, Pemex's procurement of goods and services was governed by the Procurement Law and the Public Works Law and their respective regulations, like all other entities of the Mexican federal government. This significantly limited Pemex's ability to adapt its infrastructure projects to the requirements of the international project finance market. Pemex's new procurement regime for goods, services and works has been tailored to address its needs and incentivise the development of modern infrastructure that guarantees long-term growth.

The new legal framework gives significant flexibility (compared to the Procurement Law and the Public Works Law) to procure the necessary goods, services and works by allowing Pemex to design the terms of a tender offer and the contract models as to best meet its particular needs (and the market's demands). One of the most important matters is that Pemex is allowed to accept the best overall offer participants submit (so a combination of price, terms, technological innovation and so on) instead of solely on the basis of the best economic offer as in the Procurement Law and the Public Works Law. It is expected that at least 95% of Pemex's procurement will be done under this new regime, although the Procurement Law and the Public Works Law will continue to apply as ancillary regulations to procure and lease goods, services and works that are not related to Pemex's core business within the oil industry and secondary petrochemicals.

As part of every bidding procedure, Pemex must provide a contract model that will typically contain relevant standard provisions (scope of work, payment structure, risk allocation, termination events, liabilities, liquidated damages and so on) and the provisions required by the corresponding applicable law. Once the contract is awarded its terms cannot be negotiated or amended. The new legal framework mentions in a very general manner the terms and conditions of the new services agreements to be executed. Although it has been made public that Pemex has hired well-reputed advisors to develop the model contracts pursuant to international standards and practices, the final drafts have not been made public since they are yet to be approved by the Pemex's Committee for Acquisitions, Leasing, Works and Services. Thus, the actual implementation of the new Pemex legal framework through the specific terms and conditions of the new contracts remain unknown.

"The new Pemex legal framework gives significant flexibility to procure the necessary goods, services and works"

Nevertheless, based on informal conversations with Pemex officials we anticipate that the new Pemex contracts will be structured as to adequately allocate risk and incentives so that contractors can obtain financing based on project revenues and to secure such financings with the project's assets (to the extent owned by the contractors) under the standard project finance regimes. As mentioned before, the actual financing of a Pemex contract by the contractor or supplier will depend on how Pemex has structured the procurement of specific goods, services or works and may range from (i) acquiring an asset where the payments are bullet or in instalments, to (ii) a services contract where there are monthly payments of a tariff that would cover the construction costs as well as the operation and maintenance costs, plus a set gain.

Risk analysis

The following areas are those considered to present the major legal issues that could arise in a project finance transaction anchored on a contract governed under the new Pemex legal framework.

Ownership restrictions

The legal reform recently implemented confirms the ownership restrictions regarding hydrocarbons that have always existed in the Mexican oil and gas industry. Pemex is restricted from entering into risk or profit sharing agreements or agreeing provisions for payment-in-kind of oil and gas; therefore, no exploration and production contract may be tied to Pemex's profits from the sale of oil, gas or derivative products.

In relation to upstream oil and gas exploration, production sharing agreements and concession agreements

About the author

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He represents major energy companies, project developers, engineering and construction companies, as well as lenders and investors in infrastructure projects in Mexico. Recently, Santiago has acted as Mexican counsel to the consortium formed by Mitsui & Co, Korea Gas Corporation and Samsung Corporation in connection with the development and financing of an LNG Storage Terminal located in Manzanillo, Colima, as well as counsel to Abener Abengoa Mexico and GE Energy Financial Services in the development and financing of the Nuevo Pemex gas-processing complex in Tabasco. He is also counsel to Sempra Energy in all of its projects in Mexico. Finally, he has represented various financial institutions in their participation in the financing of Mexican energy and infrastructure projects whether as direct lenders, as agents or as credit-enhancers.

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cannot be entered into by Pemex and cost-recovery petroleum is not an option. In the case of mid-stream and downstream, the exploration, production, refining, storage, transport, and firsthand sales of hydrocarbons, by-products and basic petrochemicals are exclusively reserved to the Mexican state; therefore, no concessions may be granted to private parties (except for natural gas industry and coal-bed methane).

Collateral risk and restriction to assignment

Pemex contracting rules provide that Pemex's contractors may not assign or transfer their contractual rights and obligations without Pemex's prior written authorisation. Nevertheless, collection rights are more easily assigned, but still require Pemex's prior consent. This does allow lenders to take security over the receivables under contracts with Pemex on the basis that the debt is serviced from cash flows under the relevant service contract.

Security can also be taken over the plant and equipment when owned by the relevant contractor (rather than Pemex). Where the plant or equipment is constructed by the contractor and then operated by it, secured project financings are possible based on (i) the revenue stream under the contract with Pemex and (ii) security granted over the plant and equipment. When the assets are owned by a contractor there are usually few restrictions on the contractor's ability to encumber these assets to guarantee its financing obligations; in the understanding that any step-in right granted to creditors will have to ensure that the services continue to be rendered for Pemex's benefits as per the contractual terms.

It is important to stress that there is no legal provision requiring Pemex to guarantee its contractual obligations and, in practice, Pemex never grants any form of guarantee or security in connection with a procurement contract.

Sovereign immunity under Mexican law

The new Pemex legal framework distinguishes between domestic and international obligations. International legal obligations assumed by Pemex may be governed by a foreign law, and disputes regarding commercial acts may be submitted to the jurisdiction of foreign courts or international arbitration. Disputes relating to domestic legal obligations shall be resolved before Mexican federal courts, except if arbitration was agreed by the parties.

As a result contracts governed under Mexican law would necessarily entail, in compliance with applicable law, that security cannot be taken over real property owned by Pemex in Mexico and it is exempted from granting guarantees as part of a judicial process. Pemex cannot waive to its immunity in this regard, so Pemex property can never be subject to an attachment.

Termination of contract

Although it is not certain how the termination provisions will be addressed in a contract under the new Pemex legal framework (because the model contract is not yet made public), we can anticipate that this will be structured so as to guarantee that the contractor is generally reimbursed and made whole for its investment (including debt financing) including upon termination on the basis of express termination events defined in the contract, although early termination due to contractor default will include liquidated damages. We can anticipate that the model contracts will meet international standards and practices, and will be similar to the IPP structures developed by *Comisión Federal de Electricidad* (CFE). However, we will have to wait until the model contract is released to know how these matters will be addressed by Pemex.

Nevertheless, a practice followed by most participants in large public bidding procedures has been to file very thorough questions during the clarification meetings addressing these matters so that there are better grounds to argue which expenses may be recovered and under which specific situation a contract may be terminated.

Although the new Pemex legal framework states that a contract can only be rescinded based on the specific assumptions listed in the Pemex contracting rules, these rules state that Pemex may rescind the contract based on "any other reason indicated in the contract", which could include reasons of "general interest". During the bidding procedure, as part of the clarification meetings, it might be important for the contractor (and also for its financiers) to insist on the application of clear rules and identification of risk allocation upon administrative rescission of a contract based on "general interest" reasons.

Currency risk

Pursuant to the Pemex Law, Pemex is entitled to contract financing denominated in foreign currency, without the prior authorisation from the Ministry of the Treasury. Also, Pemex is allowed to contract for goods and services where the payment obligations are denominated in a currency other then Mexican pesos.

However, it is important to note that pursuant to Mexican monetary legislation when an obligation is payable in Mexico, even if denominated in foreign currency, an obligor may discharge its obligations by paying any sums due in a currency other than Mexican currency, in Mexican currency at the rate of exchange prevailing in Mexico as determined by the Bank of Mexico. Consequently, provisions giving the other contractual party an additional course of action seeking indemnity or compensation for possible deficiencies arising or resulting from variations in rates of exchange, may be unenforceable in Mexico.

This issue has been addressed in the past by requiring the Mexican government entity to make payments in the foreign currency to an account outside of Mexico.

Liability

Pursuant to the Pemex contracting rules, each contract shall establish the applicable liability limitations based on the recommendations that the risk assessment area of Pemex issues. Therefore, we understand that liability limitations may vary from one contract to another. However, the liability limitation has been typically handled under the Procurement Law contracts such that liquidated damages cannot exceed the performance guarantee.

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Restriction to changes in the corporate structure

The Pemex Law states that the transfer of shares or partnership interests of the companies acting as contractors of Pemex or as joint obligors of these may require authorisation from Pemex. As in the assignment of assets, transferring shares or partnership interests of the company without the required authorisation from Pemex will also be considered as cause for administrative rescission of the corresponding contract. This means that lenders will need to obtain Pemex's consent to take and enforce security over such interests.

Although some of the potential risks described above cannot be avoided since they derive from statutory requirements or result from factual matters affecting Mexico, Pemex and the projects themselves, there are various ways that can help a contractor (and its financiers) to mitigate them. Once the call for a tender offer is made public, the first step will be to identify what kind of project it will be and which law will govern in order to define the kind of risks that may exist.

After the tender process concludes and the contract has been awarded by Pemex, risk allocation cannot be negotiated or modified; therefore, the only rights and remedies that a contractor would be entitled to those set forth in the corresponding contract.

Since the bid guidelines, the contract and their exhibits are the instruments that jointly govern the parties' rights and obligations, and these may not be amended or revised once the bids are tendered and the contract awarded, an interested bidder must act diligently during the clarification meetings held prior to the awarding, by asking thorough and detailed questions and presenting requests for revisions to the bid documents. These questions should be tailored in order to clearly define the contractor's obligations and scope of work, including all permitting requirements, as well as authorisation for subcontracting part of the work. The responses that Pemex provides in writing will become an integral part of the bid guidelines, even if not explicitly integrated into the bid guidelines or the contract. The questions submitted by the participants may be of a legal, technical or financial nature.

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If it is anticipated that the project will require third-party financing, it is highly recommended that the bidder make sure that any preliminary terms of the financing are adequately reflected in the bid documents, including the ability to assign contractual rights and project assets to secure financing obligations, take-or-pay structures that guarantee cash flow upon the occurrence of a force majeure event or a Pemex default, lenders' step-in rights, and clear payment obligations upon an early termination of the contract that are sufficient to cover the debt owed to financiers, among others.

Based on these premises and the obvious uncertainties deriving from a new procurement scheme, it is likely that the first projects launched by Pemex will be met with great anticipation but also significant questions. Therefore, it will be wise to anticipate any material issues and attempt to address them appropriately through the advice and guidance of knowledgeable and experienced legal advisors.