PEMEX'S MULTIPLE SERVICES CONTRACT POSES FINANCING ISSUES

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To meet Mexican gas demand over the next decade without relying heavily on high-priced gas imports from the United States,[1] Petróleos Mexicanos (Pemex) must boost its domestic gas production, an effort expected to require huge capital investments in new gas fields and related infrastructure. Although Pemex generates enormous annual revenues from its sales of oil and gas, Mexico's reliance on those revenues to meet its cash needs is likely to make it politically infeasible for Pemex to fund new large-scale gas projects itself.[2]

The Administration of President Vicente Fox and officials at Pemex have decided to address Pemex's expected shortfall in investment capital by attracting foreign capital to the new gas projects. In so doing, their challenge has been to create an investment vehicle that is both attractive to foreign investors and, at the same, skirts the edges of Mexico's constitutional and legal restrictions on private ownership and development of oil and gas, still considered bulwarks of Mexican nationalism.[3]

In January 2002, Pemex announced it would seek between US$6bn and US$8bn in private investment capital for the development of Mexican gas fields under a new investment form known as a Multiple Services Contract, or 'MSC'. As a pilot programme, Pemex hopes to award half a dozen contracts to private sector firms with significant financial resources and proven track records to explore for and produce natural gas in the potentially rich Burgos Basin located along Mexico's border with Texas.[4]

Although Pemex and the Fox Administration have gone to lengths to structure the MSC to comply with current Mexican laws by leaving in Pemex the ownership and ultimate control over gas reserves and development and production facilities, the implementation of Pemex's new MSC programme undoubtedly gives foreign investors significant new influence over the evaluation, development and operation of Mexican gas fields, and new access to important geological and geophysical information.

The MSC has already received heavy political opposition from members of the still-powerful *Partido de la Revolución Institucional* (Institutional Revolutionary Party or 'PRI'), the traditional left-wing *Partido de la Revolución Democratica* (Party of the Democratic Revolution or 'PRD'), and energy sector labour unions, and may ultimately face legal challenges, based on the argument that the MSC gives private investors 'effective control' over Mexican gas projects and associated gas reserves.

In addition to the obstacles that these special interests are likely to raise in the Mexican Congress, where President Fox's *Partido Acción Nacional* (National Action Party or 'PAN') does not have a majority of either house, the Fox Administration also faces obstacles from the judicial branch, where the Mexican Supreme Court ruled recently that the executive branch had overstepped its authority in promulgating new regulations purporting to open further Mexico's electricity generation industry to the private sector.[5] In effect, the Supreme Court ruled that the regulations in question required statutory changes to existing laws that could only be promulgated by the Mexican Congress.

To mollify the expected opposition and initiate an interchange of views from all sectors regarding the viability of the MSC, Pemex published for comment a revised generic model of its proposed MSC ('Model'). In June, it organised an industry-wide conference in Mexico City to present the MSC, and is currently

proposal for Pemex to be restructured into four separate decentralised entities to focus on different lines of business, as follows: *Pemex Exploración y Producción*, *Pemex Refinación, Pemex Gas* and *Petroquímica Basica y Pemex Petroquímica*. Centralised management functions were to be provided to these four entities by *Corporativo Pemex*.[11] The reorganisation was adopted effective January 1, 1994, the date the North American Free Trade Agreement went into effect.

The economic upheaval that ensued following the departure of the Salinas administration in 1994 left the new administration of President Ernesto Zedillo with the unenviable task of restoring the confidence of foreign investors. One daring step was to announce the opening of the Mexican natural gas downstream sector in early 1995. Under an initiative submitted to Congress in the spring of 1995, various parts of the Implementing Regulations were amended ('1995 Amendment') in an effort to foster private sector investment in the Mexican natural gas sector by narrowing the definition of the 'oil industry' that was reserved to the State.[12] The 1995 Amendment redefined the 'oil industry' exclusively reserved to the State, as follows:

1. The exploration, development, refining, transportation, storage, distribution and first sales of petroleum and those products that result from petroleum refining.
2. The exploration, development, processing and first sales of gas, as well as the transportation and necessary storage to interconnect development and processing activities.
3. The development, transportation, storage, distribution and first sales of those petroleum derivatives that are used as basic industrial raw materials, as well as gas derivatives which constitute basic petrochemicals.[13]

The 1995 Amendment also amended Article 4 of the Implementing Regulations to provide that the State would continue to exclusively pursue those petroleum sector activities defined in Article 3 and characterised as "*strategic*" under Article 28 of the Mexican Constitution. However, Article 4, now also authorised the transportation, storage and distribution of gas by both the public and private sector, with a prior permit to be issued by the *Comision Reguladora de Energia* (Energy Regulatory Commission or 'CRE').

Notwithstanding the foreign capital investment in the downstream natural gas sector generated by the 1995 Amendment, the Mexican government continues to face an ever-greater shortage of capital necessary to develop the natural gas sector. In addition, Pemex finds itself dedicating increasing amounts of manpower to administer the scores of contracts awarded each year to many different contractors with varying levels of success. The MSC is seen, therefore, as accomplishing the dual purpose of increasing Pemex's internal efficiency while at the same time stimulating outside private sector investment.

HOW THE MSC WORKS

As proposed, the MSC is a service-type hydrocarbon development contract, to be executed between *Pemex Exploración y Producción* ('PEP'), Pemex's exploration and production subsidiary, and the designated service contractor ('contractor'). The MSC is a long-term commitment by the contractor to the development of a Pemex gas field or "*work area*". The Model establishes three phases of work covering a maximum total of 20 years: a development phase (eight years); a reactivation phase (five years); and a maximum recovery phase (seven years).[14]

As an instrumentality of the government of Mexico, PEP is required to contract for works under the MSC pursuant to international bidding procedures provided for in *La Ley de Obras Publicas y Servicios Relacionados con las Mismas*, the Mexican public works law ('Public Works Law')[15]. These public bidding procedures require PEP to:

- formally publish a call for works to be performed under the MSC;
- prepare the *Bases de Licitación* (the qualification rules and other bid requirements) for the public bid;
- provide for site visits for qualified bidders and conduct meetings to clarify the bid;
- require bidders to submit, separately and in sealed envelopes, a technical proposal and an economic proposal for the project; and
- establish procedures for conducting and awarding the bid and for executing the MSC.[16]

Each bid will be made on the basis of the percentage discount the bidder proposes to apply to a set of 'original unit prices' published by PEP in the

Bases de Licitación for the project.[17] Unlike many other host country hydrocarbon development regimes that permit contracts awarded to take into account commercial factors other than price, the Public Works Law is focused almost exclusively on selecting the lowest-cost bidder. Article 38 requires PEP to award the MSC to the bidder or bidding consortium that submits the proposal that:

(a) is solvent;

(b) meets the legal, technical and economic conditions required by PEP in the published bid; and

(c) contains the lowest price (i.e. the highest discount factor) for the works solicited.[18]

This lowest-bid factor in the MSC award process will tend to favour smaller, lower-cost contractors over larger companies with big overheads.

Under the MSC, the contractor agrees to execute and administer for PEP an array of development works (geological and geophysical services, engineering services and development-related services, including drilling, completing and stimulating wells, building gas gathering lines, and supplying materials), infrastructure works (constructing and repairing access roads, constructing and installing compressors and measuring devices, preparing infrastructure sites, etc.), and maintenance works (providing maintenance for continued well operations, furnishing dehydration and compression services, monitoring production activities) in connection with the designated work area, and is required to supply the equipment, materials and other resources to complete them.[19] These activities are carried out under an agreed annual work programme, subject to a procedure for the review and final acceptance of works by PEP.[20]

Unlike 'risk-type' development agreements (e.g. concession agreements, production sharing contracts, risk-service contracts, and certain hybrids), commonly preferred by the oil giants because they award a share of the oil and gas or confer participation rights as compensation for taking the exploration and development risk in a project, the contractor under an MSC will be paid fees (in cash) for units of services and facilities furnished to the project. To comply with the Mexican Constitution and the Implementing Regulations, the contractor stipulates that all hydrocarbons remain PEP's exclusive property, that the contractor's exclusive compensation is the cash remuneration under the MSC, and that the contractor receives no preferential hydrocarbon rights or rights to participate in exploratory benefits.[21] The MSC also provides that the contractor is to receive no ownership interest in wells, gathering lines, gas pipelines and other essential fixed assets in the work area.[22]

These ownership disclaimers are broad and without exception. There is no reason to believe that legal and equitable interests of the type required to create mortgages, security interests or charges under the secured financings of a contractor would be considered legally enforceable in Mexico against the facilities, equipment and other capital assets the contractor delivers and installs within the work area covered by the MSC.

UNIT PRICING

Although some host government contracts permit the contractor for the national oil company to recover its costs and profit margins as actually incurred, the Public Works Law only permits a contractor in a Mexican public works project to be paid on the basis of 'unit prices', 'lump sum prices', or some combination.[23] Pemex has adopted a unit price structure for the fees payable to its contractors. The unit price for each item of work under an MSC contains recovery factors for each of the following:

- the direct cost of the work item;
- the indirect cost of the work item, stated as a percentage of the item's direct cost;
- the financing costs related to the work item, stated as a percentage of the item's direct and indirect costs;
- the profit margin for the work item, stated as a percentage of the item's direct, indirect and financing costs; and
- additional costs, such as designated taxes, as stipulated in the MSC.[24]

The Model provides for specific adjustments in the direct and financing cost components of the unit price based on corresponding changes over the term of the MSC in officially recognised indices. These specific cost adjustments include a foreign exchange adjustment on local currency-based costs, such as for peso-denominated labour and materials, and an interest rate adjustment tied to future changes in rates on long-term bonds determined relative to an index to be

designated in the agreement.[25] The Model also adjusts for changes in taxes directly attributable to the costs of assets, works and services,[26] but provides no specific adjustment for changes in the income tax rates or value added taxes payable by a contractor over the life of a project.[27]

In addition to these specific price adjustments, the Model incorporates by reference an automatic adjustment of unit prices to the extent required to maintain the "*economic equilibrium*" of the contract in the event of unforeseen circumstances, as provided for in Article 56 of the Public Works Law and applied under principles to be established in the contract.[28] Since this economic equilibrium adjustment would, presumably, result in either an upward or downward adjustment in the unit price, contractors should study carefully the provisions of Article 56 as applied under the principles in the MSC in order to fully understand the forward price risk of each project as it plays out over a 20-year term.

As with any turnkey contract, the contractor under the MSC is expected to recover all its costs and profit margins, and to receive full compensation for all project risks, out of the cash remuneration payable under the agreement. Cost overruns are borne by the contractor.

EXPLORATION AND DEVELOPMENT RISKS

Despite being a service-type development contract, the MSC imposes substantial exploration and development risk on the contractor. For example, to comply with the Mexican Public Debt Law, which requires public works projects to be self-financing,[29] the Model provides that the remuneration payable to a contractor is payable only in months in which there are *"available revenues"* from the work area. 'Available revenues' are defined as a percentage of the value of new production from the work area. By making the contractor's fees contingent on the success of a project (i.e. by requiring the achievement of targeted production levels before unit price payments are made), the 'available revenues' limitation subjects the contractor to the exploratory and development risk of a project, at the same time as the profit margin and cost recovery mechanisms in the unit pricing structure of the MSC limit the contractor's ability to share in a project's financial upsides.

Although some contractors might wish to view the assumption of exploration and development risks as an 'investment' or 'joint venture' with PEP in a gas project, they are not likely to be able to treat it as such for accounting or tax purposes. Since the contractor will not own the gas reserves, production, or infrastructure associated with the project, it will not be able to book its contributions to these assets on its balance sheet for financial accounting purposes, nor is it likely to be able to offset its Mexican or US taxes by deductions or credits for depletion, depreciation or amortisation.

In modeling the project risk under an MSC, the contractor should view the assumption of exploration and development risks as an economic cost associated with the delay in the MSC payment structure, as imposed by the legal requirements of the Mexican Public Debt Law. In performing project due diligence and in modeling the financial impact of the bid for an MSC, each contractor will need to determine that its expected returns from the payment of the aggregate unit price for works contracted for will be sufficient to justify the assumption of these exploration and development risks without being able to account for the funding of the MSC project as an investment for financial accounting or tax purposes.

FROM A FINANCING PERSPECTIVE

At least 40 companies have expressed interest in Pemex's MSC programme, viewing it as an important first step into an upstream gas business that has been legally closed to private investment for over 60 years.[30] Given the size and long-term character of the capital commitments required, prospective contractors will need to study the risk factors inherent in the MSC's structure that are likely to affect the ability to finance their projects. The following are some basic observations.

The MSC's structure may limit its attractiveness to many contractors. To avoid a direct challenge to the prohibition against private ownership and control of gas reserves and related facilities and other laws inhibiting foreign and other private investment,[31] Pemex and the Fox Administration made a political decision to attempt to structure the MSC in a way that complies with the current law to the maximum extent possible. In their zeal to comply with current laws and to fashion a politically acceptable deal for Mexico, they

may have created a vehicle that is structurally unacceptable to many contractors.

Few contractors, for example, will be willing to take equity-type exploration and development risks in a long-term gas project without expecting to receive equity level returns. This should be especially true with respect to vehicles like the MSC, which require the contractor to deploy significant sums of capital without the ability to consider its capital at risk as investments for financial accounting or tax purposes. Since a contractor's returns are limited to its profit margins under the MSC's unit pricing structure, Pemex will need to build-in very substantial margins in its bid requests to make MSC projects attractive to a broad enough spectrum of bidders to insure a competitive bid process.

Contractors desiring to finance capital commitments through traditional debt facilities will need balance sheets large enough to support the credits without offering a security interest in the assets of the project. Since the contractor has no rights in the gas project or its facilities and related infrastructure, secured financing will generally not be available. Moreover, since the Public Debt Law in Mexico requires each MSC project to be self-funding, contractors should not expect to receive credit enhancement from Pemex or the government of Mexico, through parent company or host country guarantees or otherwise.

Obtaining project financing may also be a challenge. Although most host government regimes permit assignment of contracts with the government's consent, the Public Works Law strictly prohibits such assignments; even assignments of collection rights are prohibited without the consent of the governmental party.[32] The Model incorporates these restrictions, including a restriction on the ability to assign payment rights.[33] Contractors desiring the flexibility to securitise their future payments through structured financings will need to determine whether PEP is willing to give its consent and to identify the terms and conditions likely to be required.

A contractor desiring the flexibility to monetise its investments under an MSC will often want the ability to sell or sell-down its interest indirectly through 'upstream transfers' of interests in companies above the contractor in its ownership chain. Although the Mexican Public Works Law does not regulate changes in control over the contractor, the Model contains a very broad provision requiring PEP's "*entirely discretionary*" consent before any direct or indirect change of control over the contractor is allowed.[34] This restriction may pose issues for a contractor's monetisation and other exit strategies for a project.

Finally, a contractor may be limited in its ability to obtain certain types of export financing for the services and facilities it provides under an MSC due to 'national content' requirements in the MSC. To qualify for support under many government-sponsored export finance programmes, such as the US Eximbank,[35] the products and services financed must have a minimum percentage of the sponsoring country's content (which, for the US Eximbank is 50%). The Model currently requires the contractor to give preference to the acquisition of goods of Mexican origin and the hiring of service by Mexican companies, provided they are competitive with regard to price, quality, delivery time and other relevant conditions,[36] which will make it difficult for a contractor to predict how much home country content will be available on any given project

Assessing the credit and contractual risks associated with PEP. As the Pemex subsidiary charged with owning, exploring for, developing and producing all of Pemex's upstream oil and gas assets, PEP is a very substantial company in its own right. It is not, however, Pemex, and because credit enhancement is not available under the MSC structure, contractors will need to model the credit risk of an MSC project using a credit rating for PEP that may well be substantially lower than the corporate debt rating for Pemex. A higher credit risk associated with these projects would, presumably, result in the bidding of higher service prices to cover the credit reserves modeled into the project risk by prospective contractors.

In assessing PEP's credit risk, contractors should take into account the difficulties that may be encountered in enforcing an arbitration award against PEP in Mexico. Although the Model provides for arbitration in Paris under the Rules of Arbitration of the International Chamber of Commerce,[37] even if a contractor is granted an arbitration award against PEP, it will still need to be able to recover on that award against the non-exempt assets of PEP. On awards that are large enough to stretch PEP's liquidity

capacity as a separate entity, this could be problematic.

In many ways, the Model expressly limits the rights of a contractor as a creditor against PEP. For example, the Model does not provide the right to assert a contractual offset against PEP, except for obligations owed the contractor under the same MSC with respect to the same work area.[38] In general, this would prohibit contractors with multiple MSCs with PEP from using one MSC to offset the other. In addition, the Model indicates that Pemex intends to restrict a contractor from utilising its home country's investment treaties in aid of any enforcement effort by providing a unilateral right of rescission in the event the contractor or one of its foreign partners "*invokes the protection of its government*" with regard to the contract.[39] Invoking the protection of a party's own government would be the first step in initiating, for example, the dispute settlement provisions under Article 11 or 14 of the North American Free Trade Agreement.

Even more fundamentally, without credit support from Pemex or its other subsidiaries or an investment agreement with the government of Mexico, neither of which is allowed under the MSC structure, the contractor will have no claim for recovery against the assets of Pemex or any other Pemex subsidiary not made a party to the MSC. Unlike these entities, which could have international assets subject to attachment under the laws of foreign jurisdiction, the vast majority of PEP's assets – oil and gas reserves, production and essential fixed assets – are constitutionally protected in Mexico and exempt from attachment and ownership by private parties.[40] This would seem to leave a contractor with only the right to attach PEP's non-exempt assets, which could be limited in number and hard to find.

Expect early political risks to be high. Especially for those contractors interested in the Burgos Field and other early MSC bids, the political risk associated with the MSC may be relatively high. As with President Fox's early effort to permit greater private investment in the electricity generation sector, the MSC programme has been a political lightning rod for challenges, particularly by Mexican nationalists opposed to foreign investment in the energy sector in general and the Mexican labour unions who may feel threatened by the increased influence of foreign investors.

Even if the Fox Administration is successful in its effort to push the programme through the Mexican Congress, there is no reason to believe that private parties opposed to the programme will not seek redress in the Mexican Courts once the bidding process has begun or even after the MSCs are awarded. Until the Mexican Supreme Court rules definitively on the legality of the MSC, contractors awarded the early bids will be somewhat at risk of having their investments aborted or materially affected by an adverse ruling in the courts.

Notes:

1. *Mexican gas demand about 4.3 billion cubic feet per day (Bcf/d), is expected to grow over the next decade to 9Bcf/d. At current investment levels, domestic gas supplies could drop to 2 Bcf/d, leaving a supply/demand gap of about 7 Bcf/d within 10 years. See Mexican Congress Begins Review of New Multiple Service Contracts, The Oil Daily, June 17, 2002.*
2. *Pemex's 2001 gross hydrocarbon sales were $261,796,000,000.00 (Mexican Pesos). See Informe Estadistico de Labores 2001, available at http://www.pemex.gob.mx/in_es_pemex01.pdf (last visited August 16, 2002). Pemex currently provides as much as one-third of the Government's revenues. Pemex Allows to Participate in Natural Gas, IPR Strategic Information Database, June 30, 2002.*
3. *On March 18, 1938, after years of disputes between the foreign oil companies and the Mexican labour unions, President Lázaro Cárdenas expropriated all foreign oil companies' facilities, ownership rights, stocks and real estate interests. Today, the upstream oil and gas business remains under federal control and Mexico celebrates a national holiday on March 18th.*
4. *Commentary, Mexico Should Allow More Competition, The Dallas Morning News, July 3, 2002.*
5. *"Congress of the Mexican United States", S.C.J.N. 22/2001 (9ª Epoca, 2001).*
6. *"Guaso: US$1.3bn will be lost per year without CSMs", El Economista, September 18, 2002.*
7. *Art. 3, Mex. Decreto que Crea la Institución Petróleos Mexicanos (Decree Creating Petroleos Mexicanos), published in the Diario Oficial (Federal Gazette) on June 7, 1938.*
8. *Mex. Const., Article 27, ¶ 4.*

9. *Mex. Ley Reglamentaria del Articulo 27 Constitucional en el Ramo del Petroleo (Implementing Regulations for Article 27 of the Constitution for the Petroleum Sector), published in Diario Oficial (Federal Gazette) November 29, 1958, as amended December 30, 1977.*
10. *Id., Art. 1.*
11. *Mex. Decreto aprobando la Ley Orgánica de Petróleos Mexicanos y sus Organismos Subsidiarios (Organic Law for Petróleos Mexicanos and its Subsidiaries), published in Diario Oficial (Federal Gazette) July 16, 1992.*
12. *Mex. Decreto por el que se reforman y adicionan varias disposiciones de la Ley Reglamentaria del Articulo 27 Constitucional en el Ramo del Petroleo, published in Diario Oficial (Federal Gazette) May 11, 1995.*
13. *Id., Art. 3.*
14. *Contractors perform the minimum work obligation in the first three years, then continue to work through the rest of the development and reactivation phases until there are no more "drillable locations." See MODEL, Clauses 9.3 (a), (b), (c) and 9.4. PEP decides whether to advance into the third Maximum Recovery Phase, based on the national interest. See MODEL Clause 9.6.*
15. *The Public Works Law governs instrumentalities and quasi-State entities. "Public works" include (a) the maintenance and restoration of personal property incorporated or attached to real estate, whether it implies the modification of the real estate, (b) exploration, geotechnical work, location and drilling works, the purpose of which is to exploit and develop oil and gas resources underground or on marine platforms, and (c) all works of a similar nature. See Public Works Law, art. 3 (Mex).*
16. *See Public Works Law, art. 28 and 31 to 39 (Mex).*
17. *See MODEL, Clause 12.*
18. *See MODEL, Clause 2.3 (e) and Public Works Law, art. 38 (Mex).*
19. *See MODEL, Clause 3.1 (a) (b) (c).*
20. *See MODEL, Clause 11.5 to Clause 11.9.*
21. *See MODEL, Clause 2.1.*
22. *"Essential" fixed assets exclude "supplementary equipment" (e.g., compressors, pumps, vessels and other equipment approved by PEP as excluded). See MODEL, Clause 42.*
23. *See Public Works Law, art. 45 (Mex).*
24. *See MODEL, Clause 10.2.*
25. *See MODEL, Clause 10.4 (a) to (c).*
26. *See MODEL, Clause 10.4 (d).*
27. *See MODEL, Clause 10.4 (d).*
28. *See MODEL, Clause 10.5 (e).*
29. *See National Public Debt Law, art. 18 (Mex).*
30. *Supra Note.*
31. *Since Mexico's PRI party, and the source of much of the opposition, continues to hold a majority in each house of the Mexican Congress, a direct challenge would not likely result in a change in the law.*
32. *See Public Works Law, art. 47 (Mex).*
33. *See MODEL, Clause 29.2.*
34. *See MODEL, Clause 29.3.*
35. *Other governments with export finance programmes, include Germany's KfW and Japan's Export-Import Bank. Each has home country content requirements.*
36. *See MODEL, Clause 35.1.*
37. *See MODEL, Clause 31.3.*
38. *See MODEL, Clause 31.4 and related Clauses 2.1, 22.1 and 29.2.*
39. *See MODEL, Clause 21.2 (i).*
40. *Model Clause 31.4 states that a Mexican court may not order precautionary attachments, attachments in aid of a judgment, or executions over assets of PEP, Pemex or its other subsidiaries under Mexican Federal Code of Civil Procedure, Art. 4.*

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