Mexican Oil Law: Protecting Foreign Investors Through International Arbitration Agreements

By Manuel Moctezuma – September 19, 2011

As anyone who follows the oil and gas industry is aware, the American federal government’s reluctance to issue new permits for offshore exploration in the Gulf of Mexico, following the dramatic effects of the 2010 Macondo oil spill, has sharply decreased offshore exploration north of the Mexican border. At the same time, Mexico has taken great strides to encourage the role of private industry in offshore development with Pemex south of the Mexican border. On May 31, 2011, for example, McDermott International Inc. announced it had entered into a $50-million contract with Pemex to build and install oil and gas pipelines in the Bay of Campeche. “McDermott gets $50M pipeline contract with PEMEX,” Forbes.com, May 31, 2011.

Although exploration and development ventures often face uncertainty in certain countries that provide limited legal recourse for private enterprises, Mexico is a country that has begun to encourage collaborative ventures between private entities and Pemex to a greater degree than ever before. This is a significant development, particularly after a recent and substantial $350-million arbitration award that KBR subsidiary, Commisa, secured against Pemex in 2009, which may provide a greater degree of assurance to potential outside partners contemplating work with or for Pemex. Press Release, KBR, KBR Receives Arbitration Award Against Pemex (Jan. 12, 2010).

Given the decreasing likelihood of expanding offshore drilling ventures in the Gulf of Mexico north of the Mexican border, concurrent with the ever-increasing incentive to pursue offshore development south of the Mexican border, energy litigation practitioners would do well to accustom themselves with the new framework and role for private ventures with Pemex, because future disputes might be resolved in arbitration.

2008 Oil Reform in Mexico

In 1938, the Mexican oil industry was nationalized through expropriation, and Pemex was created as Mexico’s state-owned petroleum company. Since then, foreign corporations have been restricted from the energy business in Mexico and forbidden from owning Mexican oil assets. For decades, foreign corporations could only assist Mexico in exploiting its oil reserves as subcontractors for a flat fee. Now, under the Oil Reform of 2008, foreign private investment is allowed and Pemex is authorized to pay foreign corporations a fee for each barrel of oil they extract plus other attractive incentives. This article summarizes the Oil Reform provisions that provide the scheme for new contracts with Pemex, as well as the provisions with respect to Pemex’s ability to enter into arbitration agreements. Notably, no constitutional amendment was required to enact the Oil Reform; rather, the Oil Act, Ley Reglamentaria del Artículo 27 Constitucional en el Ramo del Petróleo [Regulatory Act of Article 27 of the Constitution
Concerning Oil Matters], *as amended*, art. 6, Diario Oficial de la Federación [D.O.], Nov. 28, 2008 (Mex.) and the Pemex Act provide the legal framework for contracting under the Oil Reform. Ley de Petróleos Mexicanos [Pemex Act], *as amended*, art. 5, Diario Oficial de la Federación [D.O.], Nov. 28, 2008 (Mex.). The Regulations to the Regulatory Act of Article 27 of the Constitution Concerning Oil Matters (Regulations of the Regulatory Act) and the Regulations of the Oil Act implement the Oil Reform. Reglamento de la Ley Reglamentaria del Artículo 27 Constitucional en el Ramo de Petróleo [Regulation to the Regulatory Act of Article 27 of the Constitution Concerning Oil Matters], Diario Oficial de la Federación [D.O.], Sept. 22, 2009 (Mex.) and Reglamento de la Ley de Petróleos Mexicanos [Regulations of the Oil Act] [hereinafter Regulations of the Oil Act], Diario Oficial de la Federación [D.O.], Sept. 4, 2009 (Mex.).

These statutes, along with recent rulings by the Supreme Court of Mexico upholding the Oil Reform’s validity, create a unique legal setting to allow foreign private corporations to invest in Mexico’s oil sector. The statutes comprising the Oil Reform were published by the president of Mexico in the Official Gazette of the federation and have entered into force in Mexico.

The Mexican Supreme Court Validates Oil Reform

In 2009, a section of the Mexican House of Representatives challenged specific provisions of the Regulations of the Oil Act affecting contracts, claiming they were inconsistent with Section 27 of the Mexican constitution and that they authorized Pemex to agree to contractual payment schemes linked to the results of production. See Legal actions numbered 97/2009 and 98/2009 filed before the Supreme Court. In December 2010, the Mexican Supreme Court upheld the legality of the Regulations of the Oil Act. This resolution ends a constitutional challenge by opponents to the Oil Reform and gives legal certainty to prospective investors.

With the Oil Reform, activities reserved to Pemex involving petroleum refining, transportation of crude oil and byproducts of crude oil refinement through pipelines, and storage of such products, are now open to foreign corporations under limited restrictions.

Procurement, Leases, and the Contracting of Works and Services

All procurement, leases, and works and services contracts consisting of substantive production activities as referred to in the Oil Act (National Oil Activities) and any petrochemical industry not defined as “basic petrochemical” under the Oil Act must comply with the Contracting Guidelines. Procurement and leases, as well as works and services contracted by Pemex and its subsidiaries, exclusively with respect to National Oil Activities and basic petrochemical industries, shall be conducted solely in accordance with the provisions of the Pemex Act, its regulations, and the Contracting Guidelines issued by Pemex’s Board of Directors. In other words, the Public Works Act (Decreto por el que se adiciona el artículo 1 de la Ley de Obras Públicas y Servicios Relacionados con las Mismas [Public Works Act], D.O., Nov. 28, 2008 (Mex.) and the Public Sector Procurement, Leases, and Services Act (Decreto por el que
adiciona un párrafo tercero al artículo 1 de la Ley de Adquisiciones, Arrendamientos y Servicios del Sector Público [Public Sector Procurement, Leases, and Services Act], D.O., Nov. 28 2008 (Mex.), which generally apply to government contracts, apply only to contracts not concerning National Oil Activities and the petrochemical industry not defined as “basic petrochemical” under the Oil Act.

Pemex negotiates and signs contracts through its Board of Directors. For instance, the Board of Directors can now approve—without obtaining prior clearance from other government agencies—(i) business transactions with private entities; (ii) provisions applicable to Pemex and its subsidiaries for the contracting of works and services, acquisitions and leases; and (iii) investment projects and contracts exceeding amounts provided in the applicable laws.

Technical committees facilitate the Board of Directors’ work. In general, these committees have at least three members appointed by the Board of Directors, upon the nomination of its chairman and professional members. Professional members cannot be removed from committees. To oversee agreements with private entities, the Board of Directors has created the Procurement, Leases, Works, and Services Committee. The Procurement, Leases, Works and Services Committee is headed by a professional director. An official of the Ministry of the Comptrollership, as a permanent member, is present at committee meetings but holds no voting rights. With respect to private-party contracts, this committee:

- Reviews and issues recommendations to the Board of Directors on annual acquisitions, leases, works and services programs of Pemex;
- Provides recommendations to the Board of Directors on the feasibility of conducting public bids, and defines policies for contracting procedures, whether through a restricted invitation or a direct award;
- Issues determinations for agreement templates used by Pemex, required by the Board of Directors with regard to acquisitions, leases, works and services;
- Offers advice to the Board of Directors concerning material agreements, rescission, and/or termination of agreements; and,
- Presents recommendations to the Board of Directors regarding provisions applicable to Pemex dealing with acquisitions, leases, works and services exclusively related to those material activities under the Oil Act.

This committee plays a material role in the implementation of the Oil Reform. For example, it has prepared the Contracting Guidelines on procurement, leases, works and services contracting on National Oil Activities. This is a core aspect of the Oil Reform because it affords a competitive and incentivized mechanism for investors to contract with Pemex on large-scale projects.
The Pemex Act grants broad powers to the Procurement, Leases, Works and Services Committee to determine when no public bid is necessary before Pemex may contract related to National Oil Activities. The committee may also determine whether an open bid is needed, the terms of the invitations made to specific bidders, and whether to directly award a contract to specific companies. The following provide general cases in which both contracting modalities would apply in contracts not dealing with National Oil Activities:

- An invitation to at least three bidders should be made to develop technological innovations related to the goals of Pemex and its subsidiaries in the fields of engineering research, consulting, and training services; and,
- A direct award proceeds upon Pemex’s written justification as to why the circumstances of a proposed contract require a direct contracting. Direct awards are made when (i)remedying spills, toxic or dangerous gas emissions, irregular handling of hydrocarbons or any other incident caused by accident that represents a risk to Pemex’s employees, its facilities, individuals, and the environment, as well as sabotage, theft or any other illegal act; (ii) retaining professional services of accountants and legal representation in judicial and administrative matters; and (iii) securing repair and maintenance services related to industrial equipment supplied by the original manufacturer pursuant to the manufacture’s warranty.

As a result of the Oil Reform, including the Supreme Court ruling, Mexico has created a much more effective mechanism for investors to participate in the development of Pemex’s upstream and downstream petroleum assets. The new set of rules under the Oil Reform provide Pemex with the authority to negotiate and contract, through an open bidding process, with domestic and foreign corporations for the exploration, development, and production of hydrocarbons. Generally, the lowest bidder is awarded the contract.

**New Contracting Scheme on Services Contracts**
The Oil Act allows Pemex and its subsidiaries to execute any type of works and services agreements necessary to accomplish their objectives. Similarly, the Pemex Act considers both downstream and upstream activities when referring to “any type” of works and services agreements. Pemex can use the contractual legal framework of the Oil Act for contracting works and services for several industries, such as petrochemical, refining, exploration and production, transportation, and storage.

Any compensation provided in such contracts must be made in cash and must not be tied directly to revenues related to oil production. In accordance with the Oil Reform, Pemex still maintains ownership and control over hydrocarbons and hydrocarbon reserves.
The Pemex Act also requires Pemex and its subsidiaries to comply with the following guidelines when executing works and services contracts with private parties:

- No rights shall be granted to oil reserves and, as a result, contractors and providers can neither assert rights over oil reserves found during exploration and production nor register them as their assets;
- Contracts shall not contravene the provisions in Article 3 of the Oil Act, which defines the oil industry reserved to Pemex;
- Any compensation shall be agreed upon when executing the contract and must be provided in cash; no transfer of ownership of hydrocarbons is allowed, whether through any (i) interest percentages in products, (ii) interest participation in the sales value of hydrocarbons or their derivatives, or (iii) profits of the contracting entity;
- Contracts may not be implemented through a product-sharing or association scheme concerning any of the exclusive and strategic activities listed in the Oil Act and may not grant preferential rights of production percentages, sales value of hydrocarbons or their derivatives, or profits of the contracting entity;
- Oil projects may be modified according to express provisions provided in the contracts, resulting from (i) incorporation of new technology, (ii) variation of market price of equipment or assets required to perform the work, (iii) acquisition of new information obtained during the work execution, or (iv) other events that may improve the project’s efficiency;
- Payments to contractors shall be reasonable in terms of the standards and practices of the industry and consistent with Pemex’s authorized budget;
- Payments may be calculated based on fixed-scheme or predetermined formulas that take into account, mainly, technological advances used by the service provider, variations in market prices for inputs and equipment utilized in performing the services, and new information obtained during the course of the services that result in a definite price; and,
- Penalties may be imposed for contractor activities resulting in adverse impact to the environment.

Pemex must provide the Oil Commission all executed contracts for registration. The Oil Commission shall observe the restrictions applicable to the information provided by Pemex to comply with confidentiality standards. The registration requirement and confidentiality policy provide additional legal protection and confidence to investors.

**Pemex’s Model Services Contract**

Pemex recently circulated a model services contract that provides contractors with a set of provisions in major oil projects. Under the model contract, Pemex may grant rights in geographic areas and authorize corporations to earn a return based on the number of barrels produced in such geographic area. The new contracting scheme is flexible and aimed to be consistent with
international industry standards. The model contract, however, contains the following additional restrictions:

- The service provider may never receive hydrocarbons as payment for services rendered (no “taking-in-kind”);
- Mexico has the exclusive right to explore, develop, and produce these hydrocarbons, and Pemex continues to be the only permitted licensee of this right and will maintain control and direction of the Mexican oil industry; and,
- The service provider may not participate in any way in the marketing of produced hydrocarbons.

As mentioned, the payment basis for service providers has two components: a per-barrel fee and the recovery of a percentage of the contractor’s expenses. The fee per barrel is not linked to the market price of oil and gas or the price at which Pemex may sell it and, as such, is not linked to oil revenues. Moreover, the contractor is limited in its ability to book reserves as its own assets.

The Pemex Act allows additional compensation and incentives for contractors—upon agreement of the parties at the time of execution of the contract—when (i) economic benefits are achieved in a shorter time than contracted for, (ii) Pemex obtains and benefits from new technologies supplied by contractors, or (iii) other circumstances attributable to contractors result in larger profits for Pemex and better results of the work or service rendered.

The model contract requires Pemex to pay the contractor using the cash flow generated from the results of production. In addition to this existing feature for contracting with Pemex, the new framework for contracts with Pemex after the Oil Reform now include:

- The right for contractors to reduce the geographical boundaries of a block or extend them if they can offer appropriate technical, geological, and economic justification;
- Provisions for agreeing to measurements of the hydrocarbons being delivered, which are relevant to the determination of the service provider’s fee; and,
- A provision for bidders to meet and maintain specific bidder qualifications as provided on a given set of bidding guidelines for specific oil projects.

Multiple service providers may join and participate in the same services contract. The terms and conditions of the providers’ membership must be evidenced in a separate written agreement. The membership must appoint a leading member, which shall be the representative of the joint service providers before Pemex. The leading member may be removed with the prior authorization of Pemex provided the new leading member has the necessary technical and financial qualifications.
The contract will be limited to a specified amount of time ranging between 20 and 30 years. Extensions of the contracts are available subject to agreement by its parties. Additionally, Pemex may request that a service provider expand its services if hydrocarbon fields extend from within its service area to other service areas.

The service provider must provide reporting to Pemex during the course of the contract, including information on a development plan, production forecasts, annual work programs, annual budgets, and accounting and technical information. The service provider may be required to provide training and technology to Pemex employees working on a specific project. Service providers are subject to an annual performance evaluation to be conducted by Pemex.

The service provider is responsible for obtaining and installing all necessary equipment and facilities. Pemex becomes the owner of all such equipment and facilities upon installation, unless the equipment is owned by non-related parties.

As mentioned, the service provider is paid a fee for its services rendered. This fee consists of a per-barrel price set forth at the time of bidding and also a reimbursement of a percentage of expenses. Compensation may be reduced if Pemex’s cash flow from the hydrocarbon production is reduced in accordance with a predetermined formula or if the service provider is receiving excessive compensation compared with its expenses based on another predetermined formula.

The model contract provides for a rigid change of control and assignment regulation. However, a related-party assignment may not be unreasonably denied by Pemex. Assignments of rights to third parties or changes in control are subject to Pemex’s approval.

Foreign oil corporations have been exploring the Mexican oil market for years, although with increasing intensity since the slowdown in U.S. Gulf of Mexico permitting and since the entry into force of the Mexican Oil Reform. Foreign investors are currently focused on a Pemex bidding process involving three mature onshore oil fields in the southern state of Tabasco. During the authorization process for this major project, the Procurement, Leases, Works and Services Committee issued a favorable opinion regarding the model contracts, and Pemex’s contracting subsidiary, Board of Directors, and Pemex approved the contracts. With regard to offshore drilling opportunities in the Gulf of Mexico, Pemex is expected to open these fields to private investors in 2012.

**Jurisdiction and Arbitration Clauses**

The Pemex Act provides that transactions entered into by Pemex or its subsidiaries shall be governed by Mexican law, and that domestic disputes shall be resolved by Mexican federal courts, unless the contract contains an arbitration agreement. In our experience, most contracts involving foreign corporations provide for arbitration. With respect to international commercial
transactions, Pemex and its subsidiaries may agree to be subject to foreign law and to the jurisdiction of foreign courts or arbitral tribunals.

The Oil Act prohibits Pemex from agreeing to submit legal disputes to foreign courts in disputes arising under works and services contracts in Mexico and in areas under Mexican jurisdiction. But contracts can include arbitration clauses in compliance with Mexican law and international treaties to which Mexico is or becomes a signatory. Because transactions related to the oil industry are commercial in nature, the Mexican Commercial Code and Mexican Federal Civil Code also apply.

Before the Oil Reform, of course, the previous statutes that applied to Pemex allowed Pemex to enter into arbitration agreements in any type of contract, including agreements with foreign entities. Moreover, Pemex has been involved increasingly in international arbitrations in recent years. In fact, most (if not all) of the arbitrations in which Pemex has been a party have been conducted by the International Chamber of Commerce. What has dramatically changed the landscape more recently, however, is the recent International Chamber of Commerce panel award against Pemex and in favor of a private entity for hundreds of millions of dollars.

The high-dollar dispute against Pemex by KBR’s Mexican subsidiary, Commisa, was resolved through arbitration conducted by the International Chamber of Commerce. The arbitration arose out of a contract executed in 1997 and Pemex’s resulting failure to pay Commisa for the construction of two platforms and related structures off the coast of Mexico in the Bay of Campeche. Commisa received an arbitration award of approximately $350 million (U.S.) against a Pemex subsidiary for the breach. However, this award is an anomaly and history shows that Pemex honors its contracts, and when arbitration has arisen, the vast majority of adverse arbitral awards have been satisfied by Pemex. This has proven material for foreign investors in deciding whether to invest in the Mexican oil sector.

With energy exploration in the Gulf of Mexico stalled north of the Mexican border due to the Macondo oil spill, and with Mexico actively encouraging foreign private investment with Pemex in the Gulf of Mexico south of the Mexican border, it is reasonable to expect arbitrations with Pemex to increase in number and importance in the future. Energy litigation practitioners would be well-advised to familiarize themselves with the Mexican legal rules governing arbitrations with Pemex.

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