KING & SPALDING

Energy Newsletter

July 2015

TRANSACTIONAL

Project Development and Finance

Forecasting Costs and Benefits in Downstream Operation Projects

Brad Thompson and Tanner Neidhardt

Inaccurate forecasting in large-scale infrastructure construction projects often leads to underestimated costs and overestimated benefits; knowing the causes of these inaccuracies and providing for measures that lessen their incidence can be the difference between success and failure. **More »**

Transactions / Oil & Gas / Latin America

A Few Thoughts Regarding Mexico's Model Contract For Shallow Waters Under Round One

Adrian L. Talamantes

Mexico's Comisión Nacional de Hidrocarburos has published a single form of its production-sharing contract (PSC) for the shallow-water blocks under auction in Round One. This article explores some of the significant issues of which any potential bidder should be aware. **More »**

Transactions / Oil & Gas / Latin America

Latin American Upstream Oil and Gas – A Practical Guide to the Law and Regulation - *Fiscal Regimes*

Vera de Gyarfas and Tomas Lanardonne

Vera de Gyarfas, a partner in King & Spalding's Houston office, has co-authored the chapter "Fiscal Regimes" in the upcoming book *Latin American Upstream Oil and Gas – A practical Guide to the Law and Regulation*. Ms. de Gyarfas's chapter discusses the fiscal regimes of Latin American states and the different manner in which each generates revenues from the production of hydrocarbons. **More »**

DISPUTE RESOLUTION

Litigation

Texas Supreme Court Issues Opinion on Business Judgment Rule and Double-Derivative Standing That Could Affect Closely Held Texas Energy Companies

Jeremiah J. Anderson, William R. Burns, Eric A. Plourde

The Texas Supreme Court holds that the business judgment rule does not affect a plaintiff's standing in a derivative suit brought by the shareholder of a closely held Texas corporation; and a shareholder of a closely held Texas corporation has so-called "double-derivative" standing to bring suit on behalf of the corporation's wholly-owned subsidiary. **More »**

Visit King & Spalding's Energy Blog at energylawexchange.com

In The News

King & Spalding Opens New Office in Tokyo More »

Legal 500 Names King & Spalding 2015 Firm of the Year for Supreme Court and Appellate More »

Option Droit et Affaires Magazine Recognizes King & Spalding Attorneys for International Arbitration, Acquisition Litigation More »

GOVERNMENT RELATIONS

Mining and Natural Resources / Europe

Mining regulations in France – an unintelligible reform

Mehdi Haroun and Ruxandra Lazar

The French government has proposed reforms to its current mining code. While the draft reforms address prior criticisms, the manner in which these reforms may be implemented risks creating additional issues. **More »**

Renewable and Alternative Energy / U.S.

Congress Allows Export-Import Bank Charter to Expire, For Now

Lauren M. Donoghue

Congress has recessed allowing the Export-Import Bank to expire with the possibility that it may be later reauthorized. **More »**

Editorial Contacts
Charles J. (Tim) Engel III
+1 202 661 7800
tengel@kslaw.com
View Profile »

Andrew M. Stakelum
+ 1 713 276 7341
astakelum@kslaw.com
View Profile »

About King & Spalding's Energy Practice
King & Spalding's energy practice has more than 300 lawyers in the U.S., Europe, the Middle East and Asia, giving King & Spalding one of the broadest and deepest benches of energy lawyers in the world. The firm is one of the most active law firms in the global energy industry advising and representing clients on a broad spectrum of transactions and disputes, and has received top rankings from *Chambers Global, Chambers USA, The Legal 500, The International Who's Who of Oil & Gas Lawyers, Euromoney's World's Leading Energy & Natural Resource Lawyers* and *The Best Lawyers in America.* For additional information, visit www.kslaw.com/practices/Energy.

KING & SPALDING

Energy Newsletter

July 2015

TRANSACTIONAL

Project Development and Finance

Forecasting Costs and Benefits in Downstream Operation Projects

Brad Thompson and Tanner Neidhardt

Planners and promoters of the 2014 World Cup in Brazil forecast that the event would leave a lasting legacy on the country. So Brazil spent more than $3 billion renovating and erecting new stadiums to prepare for the tournament. Only a year removed, many of the stadiums are unused or underused—one serves as a parking lot for city buses; another attempts to generate revenue through weddings; and others are for sale at cut-rate prices. Few of the forecasted benefits were realized. Many in Brazil now look at the month-long tournament as a waste of resources, and even Rio de Janeiro mayor Eduardo Paes told ESPN FC that "there is regret that we even staged it."

Those are strong words for a country that loves soccer as much as Brazil. But Brazil's experience symbolizes the risks of large-scale infrastructure projects. From the Big Dig tunnel project in Boston to the Sydney Opera House, large-scale infrastructure projects face non-viability when budgeted costs and benefits differ from forecasts. Often called "megaprojects," these construction projects can cost billions of dollars, setting up significant risks for all stakeholders.

Construction of new downstream oil and gas operations, as well as capacity upgrades, in Texas and along the U.S. Gulf Coast face a number of such forecasting challenges. Refiners are expected to add more than 500 Mbpd of new domestic refining capacity in the next five years; and a large portion of this new capacity is expected to occur in the U.S. Gulf Coast region—which already hosts the five largest U.S. refineries. With significant downstream projects in the planning and the construction phases in this region, accurately forecasting the costs and benefits of these projects has never been more important.

Unfortunately, misinformation in forecasting large projects is "the norm," according to Bent Flyvbjerg, an Oxford University professor and expert in the problems and causes of megaprojects. For those considering downstream infrastructure projects, Flyvbjerg's aptly titled, "What You Should Know About Megaprojects and Why: An Overview" in the April/May 2014 *Project Management Journal*, delivers an unpleasant analysis of megaprojects: "over budget, over time, over and over again." Flyvbjerg calls this the "iron law" of large-scale infrastructure projects.

Various factors inherent to large-scale projects cause inaccurate forecasting. According to Flyvbjerg, his surveys across a 70-year period show that no such projects, regardless of the continent, state, industry, or private or public entity involved, have been immune from these factors. Owner groups must be on guard. The size and accompanying risk of large infrastructure projects is so high that cost deviations due to inaccurate forecasts are proportionally magnified. Yet because of the forecasted benefits of these projects, non-viable projects often move forward even as they risk destabilizing the owner group or wasting resources better spent elsewhere.

Regrettably, due to the inherently unique nature of each large-scale downstream project, there are few "apples to apples" cost comparisons that can be applied from project to project. Because of the shortage of references, forecasting is imprecise.

For some contractors, the potential gains of winning a high-profile project encourages bids that emphasize benefits and de-emphasize costs. Some contractors hope that once they win a bid, they can make up for cost differences over the course of a project, which can affect quality. Or if they are unable to achieve adjustments, contractors turn to owner groups who are unlikely to discontinue a project with millions (if not billions) of dollars already invested, which then affects quality, timeliness, and bottom lines.

Likewise, because some owner groups may lack cost reference examples for uniquely designed large-scale projects, and forecasted benefits are often similar among bids, owner groups often understandably consider the most economical bids. If owner groups engage a bidder who underestimated costs at the beginning, they may find themselves searching for additional financing midway through the project. This intermediate financing can cause instability, including future debt increases, deferred interest payments, and delayed benefits that made the project so attractive on the front end.

Owner groups may contribute to an underestimation of costs if they get drawn into the benefits of the project. The enthusiasm for building a plant with a share of high forecasted profits is enticing. It could raise the profile of a company to the top of certain energy fields. But such enthusiasm could lead to disaster if it clouds objective planning. This scenario is so prevalent that Daniel Kahneman of Princeton University has given it a name: "optimism bias." In *Thinking, Fast and Slow*, Kahneman describes how project planners "make decisions based on delusional optimism rather than on a rational weighting of gains, losses, and probabilities. . . . As a result, they pursue initiatives that are unlikely to come in on budget or on time or to deliver the expected returns—or even to be completed."

Project planners and promoters must also be aware of overusing "best case scenario" configurations or assumptions to reach price points that will receive approval, and ultimately, funding. "The problem," Flyvbjerg writes, "is that the dubious and widespread practices of underestimating costs and overestimating benefits used by many megaproject promoters, planners, and managers to promote their pet project create a distorted hall-of mirrors." This problem complicates the analysis of which projects deserve funding and which do not, Flyvbjerg adds.

Further, poor initial forecasting often leads to deficient project execution since it can be an indicator of ineffective or flawed planning. For large-scale infrastructure projects, these initial problems are difficult to correct; the interface of components, units, and disciplines complicates recovery efforts.

However, the outlook is not all doomsday. While the record of success in terms of accurately forecasting costs and benefits on large-scale infrastructure projects needs improvement, there are measures that can help curtail inaccuracies. Owner groups must establish internal procedures to check optimism bias. These procedures should include referencing potentially comparable projects, even as slight as they may be. The process may take downstream planners beyond projects on the Gulf coast, but the benefits are weighty. Appropriate referencing can help to generate baseline estimates and foster accurate forecasting. Owner groups may also enhance accuracy when they engage outside, independent consultants to provide objective reviews of forecasts and bids.

The contract between the owner group and contractor offers another important opportunity to lessen the incidence of forecasting fallacies on the front end. Writing strategic incentives and penalties into construction contracts provide effective measures to reduce underestimation of costs and overestimation of benefits to win bids. Owner groups and contractors should also seek well-designed dispute resolution mechanisms that foster cooperation and curb productivity declines when issues arise. Like incentives and penalties, well-drafted contractual provisions can facilitate the completion of the project—and, if necessary, establish the guidelines for recovering damages when the project's problems cause disproportionate losses for stakeholders.

Large-scale infrastructure projects do not have to end like the World Cup in Brazil, a country so crazy about soccer that it is almost unfathomable to think that hosting the holy grail of soccer events could lead to a sense of resentment for some. However, when decision makers rely on inaccurate forecasts of costs and benefits on such a large-scale, the risk of a let-down is magnified. Accordingly, downstream operators are well-advised to try to take steps to promote accurate forecasting in order to control the costs and maximize the benefits of large-scale construction projects.

This article originally appeared in the July issue of the Houston Business Journal.

Brad Thompson
Austin
+1 512 457 2001
bthompson@kslaw.com

Tanner Neidhardt
Austin
+1 512 457 2033
tneidhardt@kslaw.com

King & Spalding

Energy Newsletter

July 2015

TRANSACTIONAL
Oil & Gas / Latin America

A Few Thoughts Regarding Mexico's Model Contract For Shallow Waters Under Round One

Adrian L. Talamantes

More than six months have passed since the *Comisión Nacional de Hidrocarburos* (CNH) published the bidding terms and conditions of Round One, including a single form of production-sharing contract (PSC) for all shallow-water blocks under auction. CNH has revised the PSC three times, the last being on June 9, 2015; and it intends to award all contracts by July 15, 2015.

Of the 49 companies that expressed some form of interest in Round One shallow-water contract areas, 39 gained access to the data room and 26 prequalified to bid. One could say these figures foretell that a good number of companies will actually bid for one or more of the 14 blocks CNH intends to award this July, but it is unclear whether their interest is evenly spread across all contract areas. All fields are mature and the contract areas are small, ranging from 116 to 501 square kilometers, nine of them being under 310 square kilometers. It is noteworthy that Pemex has previously explored most of the attractive shallow-water areas in the southern Gulf of Mexico, suggesting the probability of finding easy oil is low. If true, it is likely that most fields containing hydrocarbons in commercial quantities will be small and command a high development cost.

The foregoing scenario underscores CNH's need to make an offer to the oil patch that is competitive against other E&P opportunities around the world, particularly in the current low oil and gas price environment. In the Americas, Argentina is continuously lobbying for investment in its upstream sector, though the political risk is high. Colombia's oil patch is generally considered a good bet, but the regulatory process -- especially as it relates to environmental permitting -- continuously challenges operators. Brazil, a once promising international oil and gas market, is now embroiled in an unprecedented corruption scandal that has stifled development of its reserves. Will Mexico take advantage of the other countries' shortcomings and seize the opportunity before it?

Mexico's insecurity and recent corruption scandals at various levels of government do not help its cause, and could seriously undermine the effective implementation of the country's energy reform. Moreover, the international oil industry is aware of such problems and recognizes their possible ramifications. But the oil patch is accustomed to working in such an environment, and it may take more than crime and procurement irregularities in other sectors to halt what is now an irreversible process into Mexico's modern age of international petroleum transactions. Thus, the terms and conditions of the PSC will be the most significant factor affecting the degree to which Mexico will be able to develop its oil and gas resources under the new liberalized sector.

The following are a few thoughts regarding the PSC.

Exploration and Development Periods

Length of Exploration Period

As is typical of many upstream government petroleum contracts (UGPCs), the PSC grants the contractor an initial four-year exploration period in which to carry out an approved minimum work program. The initial period may be extended for two additional years if the contractor has completed the approved minimum work program and complied with its obligations under the contract, among other conditions. Mexico's geology is less known than others; it is unclear whether the potential six-year exploration period will be sufficient for contractors to fully perform an effective program that maximizes the recovery of hydrocarbons from Mexico's shallow-water mature fields. A further two-year optional exploration period would have given the parties much-desired flexibility in this respect.

Force Majeure

The contractor may also extend the exploration period as a result of a force majeure event. While a good right in principle, the PSC does not properly address it. The PSC extends the exploration period and any evaluation period therein for any delay to the contractor due to a force majeure event, which by definition is outside a party's control. This extension, however, is not automatic and may be lost if the contractor fails to provide CNH notice of the event within five days of the date on which the contractor knew, or should have known, of its occurrence.

Such notice requirement for all practical purposes penalizes the contractor for a failure to perform a ministerial act within an uncommonly short period of time (*i.e.*, provide notice within a five-day period), and disregards the possibility that the contractor could have been actually prevented from doing work as a result of force majeure. Given the limited time contractors will have to conduct costly exploration activities in the mature fields under auction, the absence of any actual damage to the government for any delays in performing the minimum work obligation (which is guaranteed to the government through letters of credit), and the vast acreage Mexico has for further E&P activities, the above result is quite harsh and most likely unwarranted. A less punitive alternative would have been to allow the contractor to claim force majeure commencing on the date on which it actually provided notice to CNH if notice was not timely given in the first place.

Delays in Permitting

The PSC also lacks any automatic extension in the event of delays by the Mexican governmental authorities in issuing the necessary permits, which must be obtained prior to any exploration by the contractor. For instance, it would have been advisable that an extension automatically be granted in the case of delays in the issuance of environmental permits (a problem that is common in Colombia and has hampered the much-needed development of the country's reserves) -- provided the contractor has timely complied with the applicable requirements and submitted all necessary documents. The length of the extension would be equal to that of the delay.

Minimum Work Commitment

Scope

The PSC provides for a minimum exploration work commitment, which the contractor must agree to fully perform. If the contractor fails to fulfill its commitment, it will be in breach of the contract, risk its termination and be liable for liquidated damages. The minimum work commitment for each block generally includes the performance of studies; the acquisition, processing and interpretation of seismic data; and the drilling of a minimum number of wells. It is thought that this work will further CNH's goal of gathering critical information (and complementing information it already possesses) about the hydrocarbon resources located in the contract areas.

Work Units

The PSC employs the construct of a "work unit" to quantify a contractor's obligation to perform its minimum exploratory work. This has been used in other places around the world such as in the San Juan Province of

Argentina in 2006 and offshore Pakistan in 2001. Under this construct, specific types of exploratory activities are allocated a contractually-agreed number of work units, the accumulation of which will be required to proceed to the development phase. Under some UGPCs, work units afford the contractor an opportunity to determine what exploration activities to perform; and, thus, the contractor's commitment is only to achieve a number of work units within the exploration period. The PSC limits the contractor's flexibility in several important ways: it must achieve a certain number of units for exploratory studies, seismic and the drilling of wells[1] (albeit it may select which types of exploratory studies and seismic it wishes to perform from an exclusive list); it cannot pay, without defaulting, an agreed sum of money in lieu of performing the work; and it must obtain CNH's approval of its annual work program. Furthermore, the contractor cannot fix the cost of its commitment, a problem inherent to the work unit regime.

Definition of Well

The obligation to drill wells, given the expense involved, also presents issues in the context of the minimum exploration work obligation. Host governments typically seek a narrow definition of "well"; whereas, contractors prefer a broad definition that results in any well operations satisfying the commitment (*e.g.*, deepening, sidetracking, *etc*.). The broader the definition, the greater the flexibility the contractor will have in fulfilling its minimum exploration commitment. In the PSC, although the term "well" or "*pozo*" is defined fairly broad (*i.e.*, as any opening on the ground through perforation or any other means *for the purpose* of discovering, evaluating or extracting hydrocarbons), the minimum work commitment is set forth in terms of "exploration Wells". If under the PSC evaluation activities are "exploration" activities and the drilling of an evaluation well will occur within the exploration period, did CNH intend to include an evaluation well as part of the contractor's minimum work commitment? That would not be typical.

Prospective contractors must recognize that an ambiguous requirement will grant CNH greater latitude in refusing to approve an annual work program and budget. Conversely, CNH must recognize that the intent-based definitional approach of "well" looks to the subjective intent of the contractor drilling the well. This definition will cause CNH to have difficulties proving with objective evidence that a well is or is not of a certain type.

Deemed Satisfaction

There is no provision in the PSC whereby the contractor's minimum well drilling commitment is deemed satisfied when the occurrence of a qualifying event inhibits completion of the well. This raises the obvious concern that the contractor could be in breach if the well portion of the exploratory commitment is unfulfilled, regardless of the reason. "Deemed satisfaction" provisions are not uncommon, and effectively balance the host government's desire to gather information about its hydrocarbon resources and the contractor's willingness to explore for it on what amounts to a contingent fee, sole-risk basis (i.e., the contractor recovers its costs and any profit only upon commercial discovery).

Any number of events could result in the contractor being deemed to have satisfied its well drilling commitment. These include drilling the well to its objective formation; making a commercial discovery before drilling to the required formation or specified depth; discovering conditions that make the likelihood of commercial production unlikely; or encountering technical problems rendering drilling imprudent. Some of these events were contemplated in a prior draft of the PSC if only to reduce the contractor's exposure to liquidated damages for failure to fulfill the minimum work commitment. But the current draft of the PSC only provides, vaguely, that the contractor will not be obligated to perform its obligations within the technical specifications required by a work program if it encounters an obstacle to the continuation of drilling, such as impenetrable rock being encountered at a lesser depth or the finding of conditions which make the continuation of drilling an obvious danger due to the existence of abnormal formation pressure.

Commercial Discovery

Veto Power

As with most host government agreements, the contractor under the PSC must notify CNH of all commercial discoveries it makes. CNH will not have an approval right with respect to such declaration, but it will effectively have a veto power during its analysis of the contractor's development plan, which requires CNH's approval.

Exploration Commitment

One could expect that a declaration of commerciality in a small contract area, such as those up for bid under Round One, would release the contractor from further exploratory obligations under the minimum work program or exploration plan. After all, the contractor's ability to recover its costs and the government's desire to promptly receive it share under the PSC are tied to commercial production. This means that each party has a strong interest in commencing development and commercial production as expeditiously as possible. Why then require that the contractor sink additional exploration costs into a project when those funds could eventually be unrecoverable or, more beneficially, used to develop the commercial discovery that ultimately leads to cost recovery and production share for both parties?

Perhaps an elastic minimum exploration commitment would have been more appropriate; one that would change or evolve upon the occurrence of certain exploration results or the occurrence of a specific event such as a commercial discovery. If a contractor makes a commercial discovery, why not release it from its remaining exploration commitments, monetize such commitments and transfer them to the development program? This would give the contractor, the operator and party which are in a better position to maximize production from the contract area, the much desired flexibility to decide whether to continue exploration operations, to proceed with developmental activities, or both.

Gas Discoveries

Gas discoveries also require the granting of additional time for the contractor to develop a market suitable for a profitable exploitation. Sometimes the sale of gas will not only require the construction of additional processing and transportation infrastructure by the contractor and its customers, but also the implementation of an adequate legal or regulatory framework that permits making long term commitments required to amortize such investment. Given low prices of gas in North America and virtual absence in Mexico of the sale, marketing and export of natural gas by private parties, these issues can take years to resolve. Absent a contrary understanding at the outset, the contractor arguably has a legitimate interest in retaining its rights over gas discoveries and receiving meaningful extensions (to avoid mandatory relinquishment of acreage) while it develops such a framework and suitable markets.

Early Termination

Administrative Rescission

Most Latin American host government contracts grant the governmental party a termination right upon the occurrence of stated events. Some events are classified as contractual and others by legal mandate as administrative. The intrinsic nature of all such events relates to the contractor's failure to perform an obligation. The classification rests on the varying degrees of severity the government assigns to each event of default—a method that serves the interests of the host government. It matters to the contractor whether an event of default is classified as administrative because the occurrence of such an event will entitle the government to unilaterally terminate the contract and preclude the contractor from disputing such termination through judicial or conventional dispute resolution procedures. Administrative termination arises under statute as a creature of administrative law and, though it finds its way into a contract, is not contractual in nature nor will a contractor be able to bargain itself out of it. There is a view that this unfair advantage given to the government by law would be null and void under the private law of contracts. However, it is valid in Mexico and deeply-rooted in the country's public administration laws.

Burden of Proof

Following the Latin American trend and in compliance with the new Mexican Hydrocarbons Law, the PSC enumerates seven events of default that upon their occurrence will entitle CNH to terminate the contract through an administrative process. Under such process, the contractor has the burden of proving to the sole satisfaction of CNH that an event of default has not occurred, is excused or has been cured. If not met, CNH will be entitled to terminate the contract with immediate effects and without judicial declaration, much in the same manner in which the government of Ecuador terminated Oxy's Block 15 production sharing contract in 2006. Once the administrative process is concluded, the contractor's sole remedy will be to appeal CNH's decision to the Tribunal Federal de Justicia Fiscal y Administrativa, an administrative tribunal, without further recourse to arbitration or even judicial courts. Consider that upon the termination of a PSC for an administrative event of default the contractor will be required to pay damages (excluding indirect or consequential damages), perform abandonment operations and transfer to the State all machinery, tools, equipment, platforms, infrastructure and any other facilities acquired, leased or possessed by the contractor in the contract area -- all without any right to payment or indemnity from the government.

Materiality of Breach

Because of the magnitude of their investments, contractors have a legitimate interest in seeking a clear definition of the events that grant a host government the right to terminate a UGPC. Most importantly, early termination events should be limited to those that have a high level of materiality and can be measured objectively. Under no circumstances should a party be entitled to terminate a contract based on that party's subjective assessment of an event.

The PSC does not clearly define "material breaches", the uncured occurrence of which grants CNH the right to unilaterally terminate the contract. Under U.S. state law-governed contracts, the failure to define "materiality" may not be a concern to some because its meaning and scope has been thoroughly litigated in state courts and is fairly well settled. The PSC, however, is governed by the federal laws of Mexico, which has never clearly defined or regulated the term; nor does any Mexican jurisprudence address or provide guidance on its interpretation. Will a contractor's breach be material enough to warrant termination if CNH is deprived of the benefit of its bargain under the PSC or can be adequately compensated for the breach? To what extent may an arbitrator take into account the contractor's good faith and fair dealing? How will arbitrators interpret a concept that is not clearly defined in the PSC?

Other events listed in the PSC as grounds for termination are arguably not material and outside customary provisions in UGPCs: a negligent act that causes an accident resulting in damages to facilities, death and loss of production; unjustified delays in the implementation of a work program or development plan beyond 180 days; and not delivering to CNH for its approval the exploration plan or first exploration work program within 45 days of the applicable date, are just a few examples. Under many UGPCs a "material breach" is an uncured fundamental breach that frustrates the contract or destroys the commercial purpose of the agreement of the parties. Is the failure to meet a deadline really material? Should the host government be able to terminate a contract due to an accident that claims a life or damages facilities in the context of an industry where such accidents are not uncommon?

Final Thoughts

The PSC is a wonderful instrument in terms of the Mexican government's effort to attract investors to the country's upstream oil and gas sector. It incorporates structures that have been widely accepted under other UGPCs and has many provisions that adequately balance the interests of the government and contractor. The form of contract for the shallow-waters of Round One, however, does have deficiencies and has much room for improvement. There are other areas of the contract, in addition to the issues raised above, that could have been revised to make it more competitive *vis a vis* other UGPCs. Some may view the fiscal terms and significant number of non-recoverable cost items, which are perhaps a clear reflection of Mexico's burdensome tax laws, as unduly onerous in light of the auctioned properties. Others may view the administrative and reporting requirements placed on the contractor as unduly burdensome. CNH also retains quite a bit of discretion with respect to matters that may affect petroleum operations, negating any flexibility that would be afforded to the contractor by not having an operating committee.

[1] *E.g.,* for Block 1, a 194 km^2 contract area, the contractor must achieve 6,000 work units for geologic studies, 1000 work units for seismic and 50,000 work units in the drilling of one exploratory well. For Block 6, a 466 km^2 contract area, the contractor must achieve 12,000 work units for geologic studies, 5000 work units for seismic and 91,000 work units in the drilling of two exploratory wells.

Adrian L. Talamantes
Houston
+1 713 751 3253
atalamantes@kslaw.com
View Profile »

KING & SPALDING

Energy Newsletter

July 2015

TRANSACTIONAL
Oil & Gas / Latin America

Latin American Upstream Oil and Gas - A Practical Guide to the Law and Regulation - *Fiscal Regimes*

Vera de Gyarfas and Tomas Lanardonne

Vera de Gyarfas, a partner in King & Spalding's Houston office, has co-authored the chapter "Fiscal Regimes" in the upcoming book *Latin American Upstream Oil and Gas – A practical Guide to the Law and Regulation*. Ms. de Gyarfas's chapter discusses the fiscal regimes of Latin American states and the different manner in which each generates revenues from the production of hydrocarbons.

To read the article in its entirety, click here.

Vera de Gyarfas
Houston
+1 713 495 8815
vdebritodegyarfas@kslaw.com

KING & SPALDING

Energy Newsletter

July 2015

DISPUTE RESOLUTION
Litigation

Texas Supreme Court Issues Opinion on Business Judgment Rule and Double-Derivative Standing That Could Affect Closely Held Texas Energy Companies

Jeremiah J. Anderson, William R. Burns, Eric A. Plourde

The Texas Supreme Court has recently issued an opinion that could impact closely held energy companies organized under Texas law. In *Sneed v. Webre*, 2015 WL 3451653 (Tex. 2015), the Court concluded that the business judgment rule did not affect the plaintiff's standing in a derivative suit brought by the shareholder of a closely held Texas corporation. The Court also held that a shareholder of a closely held Texas corporation has so-called "double-derivative" standing to bring suit on behalf of the corporation's wholly-owned subsidiary.

In Sneed, the shareholder of a closely held parent corporation asserted a derivative lawsuit on behalf of the parent corporation's wholly-owned subsidiary against several of the subsidiary's directors, officers, and employees. The shareholder alleged that the defendants committed fraud and breached their fiduciary duties concerning the acquisition of a facility in Saltville, Virginia.

The Court first considered the role of the business judgment rule in shareholder derivative actions brought on behalf of closely held Texas corporations. A closely held corporation is defined in Texas as a corporation whose stock is not publicly traded (on an exchange or over the counter) and has fewer than 35 shareholders. The Court noted that the business judgment rule normally applies to both the board of directors' decision whether to pursue the corporation's cause of action and as a defense to the merits of a shareholder's derivative lawsuit. The Court then made clear that closely held corporations may assert the business judgment rule as a defense to the merits of such a suit. The Court went on to hold, however, that a shareholder in a closely held corporation does not need to establish derivative standing by pleading and proving that the corporation's directors failed to exercise business judgment. Specifically, the Court explained that Articles 5.14(A) and 5.14(L) of the Texas Business Corporation Act (TBCA), when read together, established that a shareholder of a closely held corporation may bring a derivative action on behalf of the corporation, and that the Legislature did not require shareholders of a closely held corporation to establish derivative standing by pleading or proving that directors failed to exercise their honest business judgment in not pursuing the corporate cause of action.

The Court next addressed double-derivative standing. In a double-derivative action, the shareholder maintains the derivative action on behalf of the subsidiary, based upon the parent corporation's derivative rights to the cause of action possessed by the subsidiary. The defendants argued that only the actual shareholder of a subsidiary corporation could bring a derivative suit in the corporation's name. The Court, however, concluded that the plaintiff, as a stockholder in the parent corporation, was also an equitable owner of stock in the wholly-owned subsidiary. Thus, in the context of a closely held Texas corporation, the Court held that the derivative plaintiff can proceed based on his or her beneficial or equitable interest in a subsidiary. In a footnote the Court attempted to limit its holding concerning double-derivative standing to the instant facts, although future litigants may attempt to expand this holding.

Sneed thus clarifies that—in the context of a closely held Texas corporation—while the business judgment rule will provide a defense on the merits in a derivative action, it will not serve as a jurisdictional bar. Derivative plaintiffs who are shareholders in a parent corporation will also have double-derivative standing to sue on behalf of subsidiaries in closely held Texas corporations. It is important to note these holdings are based on Texas statutory law and only apply to closely held Texas corporations, not to corporations that are publicly traded or have 35 or more shareholders, or to corporations organized under the law of another state (such as Delaware). The Court further explained in a footnote that its analysis would not have materially differed under the current Texas Business Organizations Code (TBOC), which replaced the TBCA. Thus, *Sneed* will have ongoing application to closely held Texas energy companies and may make it easier for shareholders to pursue future derivative actions.

Jeremiah J. Anderson
Houston
+1 713 276 7417
jjanderson@kslaw.com
View Profile »

William R. Burns
Houston
+1 713 276 7333
bburns@kslaw.com
View Profile »

Eric A. Plourde
Houston
+1 713 276 7311
eplourde@kslaw.com
View Profile »

KING & SPALDING

Energy Newsletter

July 2015

GOVERNMENT RELATIONS
Mining and Natural Resources / Europe
Mining regulations in France – an unintelligible reform
Mehdi Haroun and Ruxandra Lazar

1. Background

The current French mining code was implemented by a government ordinance on 20 January 2011 and was therefore not debated in Parliament. The mining code regulates not only mining, but also oil and gas activities, as most of the rules for these three activities are related. France has considered reforming the code since September 2012.

Although a committee consisting of elected officials, legal experts, and representatives of non-governmental organizations and industry submitted a draft of a new mining code to the government in December 2013, the reform has been postponed with no explanation by the government.

A new version of the mining code - departing from the 2013 draft - was put to public consultation by the government on 17 March 2015 (the "Draft Law"). Interested parties could submit observations until 10 April 2015.

This new version is principally aimed at bringing the mining code into compliance with certain environmental principles, providing legal certainty for carrying out mining activities and providing transparency in the decision-making process relating to mining authorisations.

Industry is eagerly awaiting enactment of these reforms as it looks for more visibility and a more secure legal framework. Indeed, a striking difference in treatment between mining activities and oil and gas activities has arisen. On the one hand, mining activities have increased in the last several years as companies have received exploration permits for copper, zinc, lead, gold, silver, antimony, tin or tungsten. On the other hand, oil and gas activities have endured significant delays in the administration's processing of applications for new hydrocarbon exploration permits, and also for the transfer or renewal of existing permits. These delays have created a highly insecure legal framework for developing hydrocarbon activities in France. In fact only two new exploration permits have been awarded since 2011, while the government has remained silent on more than 120 permit applications, which had nevertheless been declared admissible.

2. The Main Features of the Reform

The Draft Law sets out two different types of provisions. First, the Draft Law outlines in 43 articles the main principles applicable to mining activities. Most of these principles will be detailed in implementing regulations. Second, the Draft Law empowers the government to reform the mining code by way of government ordinances, and sets out the guiding principles of the reform.

At the outset, it is important to note that the Draft Law's structure is unusual in France; and the government has not yet provided sufficient explanation as to its choice of a two-step reform. Moreover, although the Draft Law's main principles applicable to mining activities are intended to coexist with the current mining code, they contradict each other in part.

Leaving aside the uncertainties and confusion engendered by this structure, the Draft Law provides an idea of the main features of the reform, which can be summarised as follows:

a. Two types of mining authorisations required

The Draft Law does not change one of the basic principles of French mining regulations, namely that all exploration or exploitation works are subject to an additional authorisation or declaration procedure.

b. Creation of a High Council for Mines ("Haut conseil des mines")

The Draft Law provides for the creation of a High Council for Mines which shall be consulted by any minister on questions related to the scope of the mining code, proposed amendments to the mining code, or administrative decisions implementing the mining code. The scope of the competences of this new body is unclear, especially as another public body, the *Conseil général de l'économie, de l'industrie, de l'énergie et des technologies*, is already entrusted with the authority to opine on decisions relating to mining titles. The Draft Law also envisages the enactment of an implementing decree.

c. Creation of a national mining plan

A national mining plan, which would be updated every 10 years, would notably include guidelines for the development of known or estimated resources, collection of data in relation to subsoil resources and their location, and a description of allowable exploration and exploitation techniques and their impacts. It is currently unclear, however, when this plan would be implemented and how the authorities would use it to make decisions relating to mining titles. Moreover, there is concern that by proscribing the permissible techniques for exploration and exploitation the plan will become outdated and fail to include the latest and most efficient techniques, thus adding an additional hurdle for investors.

d. Public information and participation

The Draft Law includes several provisions that aim at increasing public awareness and participation within the decision-making process. Current regulations have been criticized for a lack of transparency in the authorisation process and the inability of the public, who are affected by some projects, to comment or stay sufficiently informed about the decisions taken.

Therefore, the Draft Law provides that local authorities shall be informed about and consulted on the granting of mining titles. Moreover, the Draft Law provides that the issuance of a mining title might be subject to the prior implementation of an exceptional procedure of public information and participation if it relates to an environmentally sensitive area. The reinforced procedure of public information and participation shall be led by an information and consultation group comprised of local authorities, NGOs and local stakeholders and chaired by the State's representative. The group would have the power to request expert assessments and the applicant would be granted the right to submit a second expert opinion. The group must submit a report within six months (extended to twelve months, subject to approval given by ministerial order) and state how the recommendation should be handled.

e. Deadlines for the issuance of mining titles and related authorisations

One of the major issues for operators in respect of the current mining code is the length of time for regulators to assess, process and grant mining titles. For example, under the current set-up, an application for a concession is deemed rejected if no explicit decision is taken by the minister within three years. The Draft Law provides a shortened period: the administration must act within six months (for the granting of exploration titles) or nine months (for the granting of exploitation titles), with the possibility to extend this time period up to the same duration. A decree shall provide whether the silence of the administration at the end of this period will amount to a refusal or an approval of the application.

Moreover, the Draft Law and the presentation note prepared by the administration suggest that for certain authorisations relating to mining titles, an implementation decree could set out shorter assessment periods as well as a mechanism whereby an application is deemed accepted if no explicit decision is taken by the administration. Such a mechanism would be an improvement given that current applications for renewal or assignment of mining titles are implicitly rejected if no decision is taken by the administration within a very long period of time (between fifteen months and two years, depending on the type of application and mining title).

f. Environmental issues

The current mining code has been heavily criticized for not adequately considering environmental concerns. The Draft Law proposes the following changes in this respect:

- The environmental impact of the envisaged works would be taken into account at the stage of granting the mining title. Under the current system, mining titles are granted without the administration having a clear understanding about the envisaged works and techniques. The new mechanism is designed to allow the administration to carry out a proper environmental assessment at a very early stage; and

- Mining works would be subject to the regulations that apply to classified installations for the protection of the environment, with some adjustments (which have not yet been disclosed).

g. Judicial clearance of the authorisations granted under the mining code

The Draft Law allows any interested party to request that an administrative court validate the procedure upon which authorisations have been granted. By this procedure, a party would ask the court to confirm that the processing of an application was compliant with applicable rules. If the court found that the procedure had been conducted irregularly, the court would issue an injunction requiring that the breach be remediated. Conversely, if the court found that the procedure had been conducted correctly, no future claim could be brought on these grounds against the relevant authorisation. Under the current rules, claims challenging the validity of the various authorisations can, as a matter of principle, be filed within a limited period of time, *i.e.*, two months as from the granting of an authorisation. However, the duration of the court proceeding can be extremely long, *e.g.*, in excess of two and a half years before a court of first instance. While the filing of a claim against the authorisation does not legally oblige the operators to suspend their works, such a claim may dissuade them in practice from pursuing their activities. The judicial clearance procedure has been introduced to provide greater legal certainty to mining operators. However, the maximum duration of the judicial clearance procedure –up to nine months– is likely to dissuade some operators from deliberately applying for it, and the operators might continue taking the risk of claims and lengthy court proceedings.

h. Liability regime of mining title holders and operators

The Draft Law reaffirms the principle that the entity in charge of exploration works or the holder of the mining title can be held liable for damages caused by its activity and reinforces the possibility of gaining compensation for any such damages. It sets out that if the mining title holder (or the entity in charge of the mining works) is subject to an insolvency proceeding, the court dealing with the insolvency proceeding may demand that the party controlling the insolvent entity remedy any damages resulting from mining operations. If the liable entity ceases to exist or fails to remedy the damages, the State shall participate in the compensation of such damages. It is regrettable that the government preferred such a liability regime to more straightforward mechanisms such as a bank or parent company guarantee, or a provisions for a decommissioning account.

3. Comments

Some of the principles set forth in the Draft Law suggests that the government is responding to criticism expressed about the current regulations and is striving to improve the conditions for carrying out mining activities in France.

However, there is a feeling that the mountain has laboured and brought forth a mouse and that this long-awaited reform is incomplete and unintelligible. The government's choice in terms of structure is unique in France: the principles laid down by the Draft Law will coexist with those set out by the current mining code, while subsequent ordinances adopted by the government - without any debate before the Parliament - will supplement or amend such principles. The coexistence and the implementation of these various laws and regulations are likely to lead to a confusing situation; and rather than creating a more secure legal framework, it may create a less stable framework.

Moreover, the timeframe for completing the new regulatory framework for mining operations is far from clear, although it seems likely that the Draft Law will not be enacted before 2016. If one last criticism is allowed, we would point out that the Draft Law does not address one of the major issues at stake, i.e., the level of royalties that are paid for mining operations, despite the fact that an increase of such royalties could result in a better acceptance of mining operations at a local level.

This article was originally published in the Energy & Natural Resources – France Newsletter of the International Law Office.

Mehdi Haroun
Paris
+33 1 7300 3984
mharoun@kslaw.com
View Profile »

Ruxandra Lazar
Paris
+33 1 7300 3988
rlazar@kslaw.com
View Profile »

KING & SPALDING

Energy Newsletter

July 2015

GOVERNMENT RELATIONS

Renwable and Alternative Energy / U.S.

Congress Allows Export-Import Bank Charter to Expire, For Now

Lauren M. Donoghue

Congress recessed for a week-long Fourth of July break without taking up legislation to reauthorize the Export-Import (Ex-Im) Bank's charter, just days before it was set to expire. The Ex-Im Bank supports U.S. exports, including a significant amount from nuclear energy suppliers, by guaranteeing loans for foreign purchasers. The U.S. nuclear energy industry has been one of the most vocal proponents in the effort to renew the Ex-Im Bank's charter. The industry maintains that the bank enables U.S. nuclear energy companies to compete internationally through advancing U.S. interests in energy security, nuclear safety and nonproliferation. The Ex-Im Bank was previously operating under a nine month short-term extension that passed as part of a continuing resolution to fund the federal government at the end of the 113th Congress and expired on June 30, 2015.

The expiration of the Ex-Im Bank's charter had been expected as it became clear that there was no clear pathway for passage of a reauthorization bill in Congress. With the expiration of the charter, the Ex-Im Bank is unable to approve financing of new deals involving the sale of U.S. products to buyers abroad. Dan Lipman, vice president of supplier and international programs at the Nuclear Energy Institute (NEI), has said that the U.S. stands to lose billions of dollars in nuclear energy business.

The Bank's supporters nevertheless remain hopeful that the Ex-Im's shut down will be brief. Senate Majority Leader Mitch McConnell (R-KY), who himself does not support the Bank, said last week that he would allow legislation reauthorizing the Ex-Im Bank to be combined with a transportation-funding bill, which will be debated sometime in July and is expected to be signed into law. "The highway bill will be open for amendment, and it's pretty obvious that that would be a place for this vote to occur," McConnell said in a recent statement to the press. House Speaker John Boehner (R-OH), an Ex-Im supporter, has said in the past that the House will take up whatever the Senate might pass.

The Ex-Im Bank has been helping U.S. exporters by guaranteeing loans for more than 80 years and for most of that time extension of the Bank's charter in Congress has been uncontroversial. But the Ex-Im Bank has become in recent years a target of conservative Republicans, led by House Financial Services Committee Chairman Jeb Hensarling (R-TX), who liken it to corporate welfare and believe that the Bank's role could be filled by private lenders. A bipartisan majority in the House and Senate, however, still support the Bank and the votes exist to pass an extension, if congressional leaders allow it to come up for a vote.

Lauren M. Donoghue
Washington, D.C.
+1 202 626 8999
ldonoghue@kslaw.com
View Profile »
