

Integrating Exploration and Appraisal into one regulatory phase.

MAY 2020



The current situation of crude oil prices and the COVID-19 lockdown make 2020 one of the most critical years to improve the oil and gas industry: operation flexibility, cost reduction, and regulatory improvements are pressing more than ever. Mexican E&P regulatory system is divided into three main stages: Exploration, Appraisal and Development. These stages are sequential and all of them are regulated through a technical document (called Plan or Program) subject to CNH's approval. The three documents have activities and investments that, even if they may be related, are circumscribed to only one of the three documents, either the Exploration Plan, Appraisal Program or the Development Plan... BUT IS THIS THE BEST WAY?

From a technical and economic point of view, an E&P project integrates different approaches, activities, scopes, investment, and strategies. Operators and governments' objective is to get commercial production at the lowest cost possible to maximize profits during the life of the project. With this in mind, in order to start production as soon as possible there is an important opportunity to optimize pre-development activities, like the ones of exploration and appraisal periods.

In Mexican regulation, unfortunately, having Exploration and Appraisal periods separated, slows down the development of activities. For instance, it is challenging to get approval for an appraisal well that has a double purpose: i) delimiting a discovery, and ii) looking for a deeper potential productive formation. The challenge consists in the Operator documenting the same approval well in both the Exploration Plan and the Appraisal Program; and to (somehow) distribute budget and investment in separated Exploration and Appraisal projects.

In this way, the current regulation forces Operators to make two different approvals (Exploration Plan and Appraisal Program); which translates in double time and double regulatory costs for similar objectives, lower flexibility, longer project durations, and complicated logistics and supervision.

LEGAL FRAMEWORK.

The Hydrocarbons Law only recognizes the obligation of presenting two technical documents: the Exploration Plan and the Development Plan. The need for an Appraisal Program arises from the Contracts for Exploration and Extraction ("CEE") and the Plan Guidelines. According to the above, the Exploration activities and the Exploration Period may also consider appraisal activities that are mainly characterization and delimitation of a Discovery; however, this is only by definition.

The regulation only recognizes one scenario in which the Appraisal Program integrates into the Exploration Plan, and one in which the Appraisal Program is not necessary:

ARTICLE 45 OF CNH'S PLAN GUIDELINES:

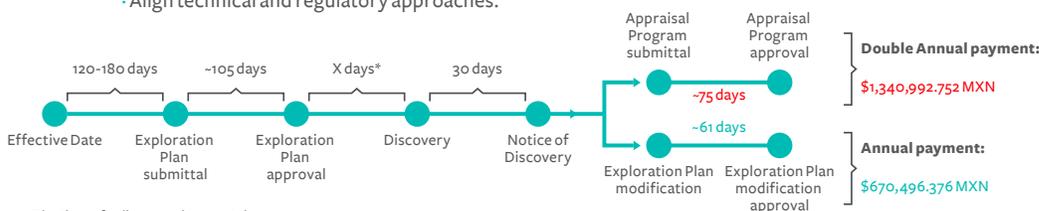
Second paragraph: "The Appraisal Program may be integrated as part of the Exploration Plan when the validity of the Entitlement or Contract begins in the appraisal of a Discovery, or a previously discovered field or reservoir without production."

Sixth paragraph: "It will not be necessary to present an Appraisal Program when, by the characteristics of the Discovery, its dimension, extension, original volume, and productive potential can be determined."

PROPOSAL FOR REGULATORY IMPROVEMENT.

Integrating Appraisal activities into Exploration and Development Plans will allow to:

- Reduce time to get to the development stage or to determine a non-commercial discovery.
- Lower regulatory cost.
- Increase operational flexibility (mainly for well drilling).
- Align technical and regulatory approaches.



*The time of a discovery is uncertain.

These modifications will benefit both, government and Operators. The Appraisal Program can be maintained, but regulation would allow flexibility in documenting appraisal activities in the Exploration Plan. In this way, Operators can present more comprehensive projects lowering the need for additional documents from operational changes.

Given that appraisal activities are also used to support a Development Plan, this proposal may be applied to Development regulations with specific benefits, that will be further discussed in a separate publication.

SPECIFIC ASPECTS OF THE PROPOSAL:

For this to happen, a modification of the Plan Guidelines is needed (as well as the related costs regulations of the Mexican Petroleum Fund and the Ministry of Finance). The main changes would be as follows:

- **Allowing the integration of Appraisal activities into Exploration Plan:** the Appraisal Program will no longer be an independent administrative procedure. Depending on the maturity level of the Contractual Area or Entitlement, the Exploration Plan can be approved with appraisal activities, and any change in the exploratory strategy may include additional appraisal activities and objectives (including the ones derived from a discovery).
- **Shared objectives:** the activities considered in the Exploration Plan (including appraisal activities) will have exploratory and appraisal objectives, so the operation becomes more flexible and efficient.
- **Modifications to the Plan:** the modification assumptions for the Exploration Plan and the Appraisal Program are already very similar, so they can be merged; and only include one more assumption referring to the addition of appraisal activities derived from a discovery.
- **The Appraisal Program does not disappear:** the CEE considers the Appraisal Program and Period as an obligation, so the Plan Guidelines shall specify that the Appraisal Program and Period will be part of the Exploration Plan. The Exploration Plan shall be valid through the Exploration and Appraisal Periods, according to the CEE.
- **Cost reporting:** given that Exploration Plan annual budget will include appraisal activities, the allocation of investments will become easier and flexible.
- **Regulatory burden:** the Operators will only pay for an Exploration Plan approval or modification. The annual supervision payment will be lower and supervision by CNH will be easier.

Talanza Energy is a consulting firm specialized in regulatory compliance in the Mexican energy sector. We guide our clients into achieving a fast and seamless execution of their projects as we align their operation objectives with the compliance of all regulatory requirements.

ANALYSTS



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We are a unique firm integrated by experts in energy regulation and public administration, conformed by a professional team with vast experience in the evolution of the energy sector during the last 10 years.

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