Huge Discovery Highlights Mexican Unitization Policy Requirements

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Mexico's Zama-1 wildcat well – drilled in July 2017 – delivered a huge and truly historic oil discovery. It has also highlighted the need for clear rules on developing oil and gas fields that span separate lease areas held by different owners.

This issue needed to be addressed – not only to ensure timely development of the Zama field, but also to ensure that Mexico maintains the recent exploration momentum triggered by its fiscal and regulatory reforms.

The Zama-1 well – drilled in shallow waters off Mexico's Gulf Coast – delivered a welcome surprise, revealing that the field was considerably bigger than expected. Zama has 1.4-2 billion barrels of oil in place. This makes it the world's fifth-largest oil discovery in the past five years – and the fifteenth largest in the past 20 years.

It was also the first major Mexican discovery by an international consortium since the energy reform was enacted. The partners are US-based Talos Energy (operator and 35% equity), British company Premier Oil (25%) and Mexican company Sierra Oil and Gas (40%). This is significant as Mexico's national oil company – Pemex – had a monopoly on exploration and production for almost 80 years. This only changed when a series of reforms in 2014 allowed foreign companies – and Mexican private companies, such as Sierra – to enter Mexican E&P.

But in announcing the Zama discovery, Talos Energy acknowledged that the field "could extend into a neighboring block." That neighboring block is held by Pemex, which has said it wants its share of production from Zama. The Government agrees. Deputy Energy Minister Aldo Flores told Bloomberg that: "If there's enough evidence and certainty that the discovery extends into Pemex's block, then it would have to be shared." Governments want to maximize their income from any resource project, so it is not surprising that Mexico has introduced a form of unitization into their regulatory policy.

This March, SENER released its new regulations on this topic, adhering to international best practices and drawing on strong models devised by other countries in order to foster a strong local oil and gas sector.

It is common for fields to straddle license or contract area boundaries. Even when permit areas have been drawn-up with the intention of avoiding such situations, geology can deliver surprises. In such situations, governments have a choice of following the "rule of capture"; or implementing "unitization"; or a combination of both.

Under the rule of capture, the first person or entity to "capture" resource owns that resource even if it has been drained from the subsurface of another person's or entity's land or license area. In contrast, unitization aggregates adjacent license areas – or the portions of those areas that contain a shared reservoir – as one unit. Each owner receives a percentage interest in the unit and shares the develop costs proportionately.

Unitization was developed primarily because the rule of capture creates incentives that can lead to undesirable consequences from the government's perspective. The rule of capture encourages each party to develop a resource more quickly than its rivals can. This leads to fast-paced drilling programs, rushed field development and poor reservoir management. It can also lead to unnecessary duplication of facilities. The result tends to be lower resource recovery, higher overall costs and lower overall profits. This means less revenue for government – lower royalties and smaller tax take.

In contrast, unitization encourages more considered development of resources and efficient use of infrastructure. Participants operate in a predictable system that delivers a fair and equitable share of resources. Governments attract more investment and receive better returns. There are also environmental benefits – fewer wells, pipelines, producing centers and operating bases are needed to develop the same resources, which reduces emissions and project footprints.

According to the Mexican regulations recently published, when evidence of a shared reservoir exists operators must notify SENER and propose a preliminary unitization agreement with an initial duration of up to 2 years. The preliminary agreement must be consistent with development plans approved by the CNH for the subject field/reservoir. Subsequently, the operator will need to provide a final unitization proposal on behalf of all engaged parties for managing the shared reservoir.

As arbiter, SENER will be responsible for settling disputes. Operators, at their own expense, can request the use of an independent arbiter too. If an agreement between operators cannot be reached, SENER or the independent arbiter would determine the terms and conditions of the final unitization proposal based on "principles of economics, competition, efficiency, legality, transparency, industry best practices and best use of the hydrocarbons," according to regulation.

Sproule can see several reasons why Mexico supports unitization

- In Mexico, undeveloped resources belong to the nation's citizens, rather than the individual landowner, thus increasing the government's incentive to maximize returns.
- The country's oil and gas reforms have been subject to intense political dialogue. Voters will want to know that the returns on oil and gas projects are being delivered back to the nation and are being maximized.
- The first case for unitization will be Zama – a huge discovery where the national oil company has a stake in the outcome.
- Opening up Mexico's Gulf of Mexico waters could lead to discoveries that straddle the US-Mexico boundary. Mexico will want to demonstrate its strong and clear unitization rules to support international negotiations with respects to developing such resources.

The Zama discovery has confirmed Mexico's rich oil and gas potential. Many oil and gas companies are excited by Mexico's potential, so it is beneficial that Mexico has released their unitization framework, which now offers greater predictability to investors.

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