EPC IN THE MEXICAN ENERGY MARKET

Due to the effects of the Long-Term Power Auctions, the Oil Bidding Processes and opportunities for transporters, developers and producers to build new conventional and renewable power plants, and rigs and pipelines to supply the demands of new projects, the current trend in Mexico is the construction of the infrastructure needed to supply new markets and fulfill obligations under agreements and awarded licenses. As evidence of this trend, the Mexican government plans to arrange for the construction of 18 new projects in the power generation sector alone (two wind, two geothermal, two hydro, and 12 combined-cycle), likely through engineering, procurement, and construction (“EPC”) contracts.

I. THE ESSENCE OF AN EPC CONTRACT

This form of contract sets out the relationship between the principal or owner (“Owner”) and the contractor (“Contractor”) for the provision of professional or technical services in connection with the construction of a specific plant or facility (“Project”). Under EPC contracts, the Owner enters into one contract with the Contractor, which then enters into additional contracts with subcontractors for the performance of specified portions of the work needed to construct the Project. The Contractor is responsible for not only the engineering aspects of the Project, but also for the procurement of equipment and the design and construction of the Project. Thus, an EPC contract enables the Owner to manage risk more effectively while allowing the Contractor to allocate tasks to itself and to subcontractors that specialize in the specific types of work they agree to perform.

There are numerous exclusive characteristics of an EPC contract:

- The engineering design phase is typically paid for on a lump sum basis. The comprehensive services range from initial conceptualization (referred to as basic engineering) to detailed engineering designs.
- The construction phase is typically paid for in lump sums based on the achievement of milestones and an agreed schedule of payments for each.
- The procurement phase is often paid for in lump sums per item, though this may vary, with different labor rates applying to different task requirements.
- The Project must pass several tests in order to be considered complete.

EPC contracts should address the following issues:

- Commencement and completion dates/rulings on (full or limited) notice-to-proceed and provisional and definitive certificates;
- Liquidated damages and trigger points;
- Financial closing provisions/availability of funds, tranches, and step-in-rights;
- Conditions precedent/licenses, permits and environmental rulings;
- Caps on liabilities;
- Indemnities;
- Entitlements to extensions of time/change orders;
- Insurance/assignment;
- Force majeure and governmental extraordinary events;
- Intellectual property rights;
- Interface issues between the Contractor and the operator and in the case of split EPC contracts;
- Tests: mechanical, performance and interconnection;
- Warranty and independent certification of key components;
- Environmental considerations;
- Assignment;
- Early termination; and
- Governing law and dispute resolution.

Provisions related to the specific technology involved in the Project should be included in the contract. For instance, provisions regarding metering should be included for renewable power generation Projects, while interconnection with associated gas infrastructure should be included for thermo-electrical Projects.

For the benefit of both the Owner and the Contractor, there must be a clear scope and concept before tender selection. The Owner must be able to evaluate the Contractor’s progress based on performance and prescriptive specifications (milestones) and to follow such progress (generally through Gant diagrams) so deviations from the agreed completion schedule can be addressed promptly after they are identified.

Contractors must deliver a completed Project for a guaranteed price by a commercial operation date (COD). This means that the Contractor, not the Owner, will be responsible for any additional costs or penalties that may be imposed by the Owner’s client under back-to-back (B2B) provisions. If the Project fails to achieve the specified level of performance (thus the importance of completion tests), the Contractor may incur financial liability.

A significant benefit of EPC contracts is that they allow the Owner to engage with just one Contractor, which then manages all of the relationships with its subcontractors under B2B. This allocation of tasks makes it easier for the Owner to oversee the Project and evaluate progress based on performance as the Contractor and its subcontractors complete each phase of the Project. Although Contractors accept more risk in an EPC contract related to the coordination of design, construction and
procurement, the structure enables them to act more efficiently to lower the ultimate cost of constructing the Project.

II. **MEXICAN LEGAL ASPECTS TO CONSIDER**

In terms of Mexican law, including without limitation the Power Industry Law and Hydrocarbons Law, some specific aspects should be considered in relation to the drafting of EPC contracts, including those related to (i) unions and sub-contracting rules imposed by the Ministry of Labor, (ii) social impact assessments, (iii) land possession and agrarian property (“ejido”), and (iv) rights-of-way of evacuation and interconnection infrastructure.

Under Mexican law, a Contractor may have some rights with respect to the Project even if a third party steps in to fulfill the Contractor’s obligations after a default, and the Owner may not be entitled to assert claims with respect to the Contractor’s previous work if the Contractor has received full payment. To address this issue, specific waivers should be included in respect of the Mexican Civil Federal Code, including those related to time extensions or tacit assumption of completion.

Last but not least, Mexican taxation must be considered since performance under an EPC contract may involve a number of tax issues that must be addressed. For example:

- From an income tax perspective, performing work under an EPC contract may result in the creation of a permanent establishment of the Contractor in Mexico, which would allow the Mexican government to tax any income attributable to the Contractor’s work on the Project.
- From a Value Added Tax (“VAT”) perspective, the acquisition of goods or services in Mexico in order to perform work under an EPC contract will likely result in VAT charges. If not properly provided for in the contract, these charges could significantly alter the profitability of the contract for the Contractor.
- The acquisition of real estate, or in some cases personal property, may trigger state taxes, which could increase the cost of performing work under an EPC contract.

If you have any questions about the information contained in this Client Alert, please contact the Thompson & Knight attorney with whom you regularly work or one of the attorneys listed below.

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