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Landmark Mexico Oil Reforms Pose No Simple Task

By **Keith Goldberg**

Law360, New York (December 13, 2013, 8:14 PM ET) -- Groundbreaking reforms Mexican lawmakers approved Thursday opening the country's nationalized oil industry to private participation have sent a jolt of excitement through the energy industry, but experts say hard work remains in creating the mandated regulatory regime and potential agreements between the government and foreign oil companies.

The reforms, which involve amending the Mexican Constitution, go even further than the ones proposed by Mexican President Enrique Pena Nieto earlier this year. They would allow for profit-sharing, production-sharing and licensing agreements between private firms and state-owned Petroleos Mexicanos, commonly known as Pemex, which has controlled exploration and production since nationalization in 1938.

The reforms would also allow companies to potentially book reserves — essentially, the amount of oil and gas that can be economically recovered from a field or project — to its balance sheets in accordance with U.S. Securities and Exchange Commission regulations. It would even allow companies to own the oil and gas once they're pumped from wells, after paying royalties and taxes. Mexico would still own the hydrocarbons while they're underground.

A majority of the nation's state legislatures must now approve the changes, but that's seen as a formality because most of those legislatures are controlled by the political parties backing the changes: Pena Nieto's Institutional Revolutionary Party, or PRI, and the National Action Party, or PAN, which had pushed for an even more dramatic overhaul.

"This is sort of a marriage of the two views, and I think it speaks volumes about the democratization of Mexico in that this proposal tried to reconcile two different views having a common goal into a synthesized bill," Shearman & Sterling LLP counsel Alexandro Padres said. "We went from a presidential proposal that essentially said that you will have profit-sharing contracts as a single vehicle for private investment to basically any type of vehicle that proves worthy depending on the profitability of the asset and its associated risks."

The legislative and regulatory roadmap sketched out by the reforms clearly loosen Pemex's 75-year stranglehold on the Mexican oil and gas industry. Yet the timeline for implementing the reforms is ambitious. Once they're signed into law, Mexico's Congress has 120 days to enact supporting legislation, which includes rewriting the country's decades-old petroleum law.

Meanwhile, the executive branch has 365 days to create the regulatory regime that will create and administer the upstream contracts between Pemex and private companies and the framework for private participation in the midstream and downstream sectors, oversee oil and gas revenue, even establish environmental protections.

"The reality is: This is a gargantuan task," Padres said. "The closest example you can come to in the U.S. is maybe the Affordable Care Act and Dodd-Frank, in terms of its depth of coverage and scope."

But Jose Valera, the co-head of Mayer Brown LLP's oil and gas practice, says the task will be made easier by the fact that Pena Nieto was just elected last year and Congress is controlled by members of PRI or PAN.

"You're seeing all of this in the first year of a six-year presidential term," Valera said. "Pena Nieto has plenty of time, politically, to see through the implementation."

For the energy industry, successful implementation will come down to the language of the production-sharing, profit-sharing and licensing agreements, experts say.

"How will those formulas be calculated, how will [private companies] be paid, and how they will pay the Mexican state in terms of taxes and other contributions in order to participate in these agreements?" said Jose Antonio Prado, a former legal official at Mexico's energy ministry and Pemex who is now a Mexico City-based partner at Holland & Knight LLP. "That's absolutely the key point of this."

The structure of the agreements may depend on the oil and gas assets being developed, says Akin Gump Strauss Hauer & Feld LLP partner Steven Otillar, who handles both domestic and international energy projects. Pemex desperately needs an injection of capital and technical knowledge in order to boost flagging oil and gas production, but the need is especially acute in the country's deepwater and shale gas plays.

"If there's a lot of exploration risk, or there's a high technology component, I think you're going to see a certain regime that will be structured in a way to incentivize an international oil company to pursue these projects," Otillar said. "If you have mature fields, or projects that carry a lower exploration risk, I think you'll see more of a service contract model, where you'll have payment based on production."

Valera added that the level of foreign investment also would depend on the pace and scale at which Mexico opens up the industry — for example, which exploration and production areas it makes available.

Mexican officials have consistently said they'll draw on the experiences of state-private partnership in countries such as Norway, Brazil and Colombia in crafting their agreements, says Baker Botts LLP partner Carlos Sole.

"I think industry is expecting [the government] will offer economic conditions that will be internationally competitive and attractive to foreign investors," Sole said.

But if there's one thing everyone is sure of, it's that the reforms breathe new life into a moribund Mexican energy industry and could reshape the global energy market. Mexico is already one of the world's largest oil producers, pumping out 2.5 billion barrels of crude oil per day in 2011, but production has steadily fallen since 2004, according to the U.S. Energy Information Administration, which expects it to continue to decline if no major technological or policy changes intervene.

Mexico has an estimated 10 billion barrels of proven oil reserves, as well as one of the world's largest shale gas resource bases, yet it currently imports most of its gas from the U.S. And while an increasingly self-reliant Mexico could create some market tensions with its northern neighbor, experts say it also could lead to a flurry of cross-border infrastructure projects and create outlets for U.S. energy products, such as more exports of liquefied natural gas or increased gas use in the shipping and transportation sectors.

Add oil-sands and gas-rich Canada to the mix, and the global energy axis could eventually tilt toward North America, according to Valera.

"At the North American level, we're going to see a more integrated market that is self-sufficient and an exporting powerhouse," Valera said.

All of these changes won't happen overnight — not with a Mexican oil and gas industry that's been controlled by one player, Pemex — for the past 75 years. But in amending the Mexican Constitution, lawmakers have already cleared the biggest hurdle in the liberalization process, experts say.

"The dam is broken," Otillar said. "If they were able to use as much political will as they did to change to Constitution, they're not going let regulatory blockages slow them down, in my opinion."

--Editing by Elizabeth Bowen and Richard McVay.
