

A NEW FRONTIER MEXICO'S ENERGY REFORM

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Introduction

In December 2013, the President of Mexico signed a historic energy reform bill into law, eliminating a restrictive legal framework that has limited private investment and participation in the country's energy industry for more than 75 years. The reform is widely expected to result in a significant influx of private capital, technology and technical expertise into Mexico's upstream, midstream and downstream oil and gas industries and its electric sector.

The reform includes amendments to articles 25, 27 and 28 of the Mexican Constitution and 21 transitional articles (*transitorios*) or directives that detail how the Congress and the executive branch are to implement the constitutional reform. In short, the reform:

- Opens the upstream oil and gas sector to private investment and competition by ending the monopoly of the national oil company, *Petróleos Mexicanos* (PEMEX), and introducing a new contractual framework in which private parties can be awarded risk-sharing contracts (license, production-sharing and profit-sharing contracts) either directly by the government or in association with PEMEX;
- Gives PEMEX the opportunity to retain acreage that it already has under production or that it is actively exploring in a "Round Zero";
- Allows private parties to report for accounting and financial purposes oil and gas contracts and the expected benefits arising from those contracts, essentially permitting the "booking of reserves" (subject to applicable securities laws);
- Opens the oil and gas downstream and midstream sectors to private investment and competition;
- Creates a fully open and competitive wholesale electric generation market by, among other things, reducing the control of the sector by the state-owned power utility, *Comisión Federal de Electricidad* (CFE);
- Introduces corporate governance changes and more

budgetary autonomy to PEMEX and CFE; and

- Creates the Mexican Petroleum Fund, a sovereign natural resources fund, to administer, distribute and invest revenues from the country's hydrocarbon resources.

The transitional articles trace, in broad strokes but with specific deadlines, how the reform is to be implemented. Full implementation of the reform will require the Mexican Congress to pass additional so-called "secondary laws" that will detail, among other things, the terms, conditions, royalty structures and tax rates of private participation and investment in the country's energy industry. Congress must pass the necessary secondary laws within 120 calendar days of the reform law's enactment (i.e., by April 20, 2014).

I. Upstream Oil and Gas Sector

Background.

Prior to the reform, Article 27 of Mexico's Constitution provided that, in regard to oil and gas resources, "*no concessions or contracts shall be granted ... and the Nation shall carry out the exploitation of those substances, under the terms set forth in the respective Regulatory Law.*"¹ Similarly, prior to the reform, Article 28 of the Constitution provided that hydrocarbons and basic petrochemicals were "strategic areas" reserved exclusively to the state.² Accordingly, the Constitution, together with two federal statutes, the PEMEX Law (*Ley de Petróleos Mexicanos*) and the Regulatory Law of Article 27 of the Constitution (*Ley Reglamentaria del Artículo 27 Constitucional en el Ramo del Petróleo*), granted PEMEX a monopoly over every step of the petroleum value chain, including exploration, production, distribution, storage, refining and marketing of petroleum and petroleum products.³ This legal framework also restricted the consideration payable by PEMEX to private companies under service contracts, prohibiting payments in kind or otherwise sharing in production, and prohibiting any form of sharing or allocation of sales proceeds or profits.⁴ A private company, therefore, could not own production, share in the proceeds from

¹ Constitución Política de los Estados Unidos Mexicanos, *as amended*, Art. 27 (pre-reform), Diario Oficial de la Federación [DO], 5 de Febrero de 1917 (Mex.).

² Constitución Política de los Estados Unidos Mexicanos, *as amended*, Art. 28 (pre-reform), Diario Oficial de la Federación [DO], 5 de Febrero de 1917 (Mex.).

³ Ley Reglamentaria del Artículo 27 Constitucional en el Ramo del Petróleo [Petroleum Law of 1958], *as amended*, Diario Oficial de la Federación [DO], 29 de Noviembre de 1958 (Mex.); Ley de Petróleos Mexicanos [Pemex Law], Diario Oficial de la Federación [DO], 28 de Noviembre de 2008 (Mex.).

⁴ Petroleum Law of 1958, art. 6 (Mex.).

the sale thereof, or share in the profits from the project. As a result, there has been no meaningful private investment or participation in Mexico's oil and gas industry for decades. The reform's amendment of Article 27 of the Constitution repeals these restrictions and establishes that the State may grant contract rights to the country's oil and gas resources to private parties.⁵

New Contract Framework.

The reform establishes a new contractual framework to govern upstream oil and gas exploration and production. The reform provides that "maximizing the Nation's revenues" is to be the State's guiding principle in implementing the new framework and choosing the contractual model for a particular area or project.⁶ The reform expressly provides that the contractual framework shall include:

- Licenses;
- Production-sharing contracts;
- Profit-sharing contracts; and
- Pure service contracts.

The law also provides that this list of contract types is not exclusive and that the contract types named in the article are "among others" available for use by the State in developing the country's oil and gas resources.⁷ Essentially, this means that Mexico is not limited to choosing between licenses, production-sharing, profit-sharing and service contracts but has the flexibility to choose among a combination of these contractual frameworks. As noted above, Congress is required to pass secondary legislation detailing this contractual framework as well as the applicable taxation and royalty system within 120 calendar days of the enactment of the secondary laws.

The first oil and gas bid round is expected to occur around June 2015, and is expected to include shallow areas offshore, deepwater, onshore shale formations, mature fields and extra-heavy oil fields, including certain areas currently held by PEMEX.

New Regulatory Framework for Upstream Contracts.

The primary responsibility for implementing and regulating Mexico's new legal framework for upstream contracts is allocated among the following regulatory bodies:

- The **Ministry of Energy** (*Secretaría de Energía*) is charged with:
 - issuing energy policy;
 - selecting the geographic areas for upstream contracts;
 - determining the areas that PEMEX will retain in the Round Zero, and
 - designing upstream contracts and establishing the technical and financial requirements for bidding (with assistance from the National Hydrocarbons Commission).⁸
- The **Ministry of Finance** (*Secretaría del ramo en materia de Hacienda*) is charged with developing the fiscal terms and economic conditions applicable to upstream contracts.⁹
- The **National Hydrocarbons Commission** (*Comisión Nacional de Hidrocarburos*) is charged with:
 - conducting bidding processes for exploration and production contracts;
 - collecting geologic and operational information;
 - evaluating bids and awarding contracts;
 - providing technical assistance to the Ministry of Energy on various matters; and
 - monitoring exploration and production plans to ensure compliance with the contracts and maximize productivity.¹⁰
- The **Energy Regulatory Commission** (*Comisión Reguladora de Energía*) is charged with:
 - regulating and granting permits for the storage, transportation and distribution of oil, gas, petroleum products and petrochemicals; and
 - regulating third-party access to transportation pipelines and the storage of hydrocarbons and their derivatives, and firsthand sales of such products.¹¹
- The newly established **National Agency of Industrial Security and Environmental Protection of the Hydrocarbon Sector** (*Agencia Nacional de Seguridad Industrial y de Protección al Medio Ambiente del Sector de Hidrocarburos*) is charged with regulating and overseeing health, safety and environmental matters relating to oil and gas operations.¹²

⁵ Constitución Política de los Estados Unidos Mexicanos, *as amended*, Art. 27 (post-reform), Diario Oficial de la Federación [DO], 5 de Febrero de 1917 (Mex.).

⁶ Decreto por el que se reforman y adicionan diversas disposiciones de la Constitución Política de los Estados Unidos Mexicanos, en Materia de Energía, Diario Oficial de la Federación [DO], 20 de Diciembre de 2013 (Mex.) (hereafter "Energy Reform Bill"), Transitional Article Four.

⁷ Energy Reform Bill, Transitional Article Four.

⁸ Energy Reform Bill, Transitional Article Ten(a).

⁹ Energy Reform Bill, Transitional Article Ten(b).

¹⁰ Energy Reform Bill, Transitional Article Ten(d).

¹¹ Energy Reform Bill, Transitional Article Ten(c).

¹² Energy Reform Bill, Transitional Article Nineteen.

Round Zero.

Before giving private companies the opportunity to bid for contract areas, the reform establishes that there is to be a “Round Zero” (*Rondo Cero*) during which PEMEX will have the opportunity to request the right to retain areas that it either already has under production or that it is actively exploring.¹³ After the Round Zero, in the upcoming rounds PEMEX is to compete on an equal footing with other companies in obtaining additional contract areas through public bids.

On March 21, 2014, PEMEX submitted its Round Zero request to the Energy Ministry, meeting the 90-day deadline established by the reform bill. The reform required PEMEX, in its application, to:

- specify the area, depth and term of the requested allocation; and
- demonstrate that it possesses the necessary technical, financial and administrative capabilities to carry out exploration and production activities in that area in an efficient and competitive manner.¹⁴

As reported by the Energy Ministry, PEMEX requested 100% of all producing areas, 83% of Mexico’s proven and probable reserves (2P reserves) and 31% of Mexico’s prospective hydrocarbon resources. Notably, PEMEX requested deepwater areas.

The reform provides that as long as PEMEX shows it is qualified to operate in a particular field or area, the Ministry of Energy is to grant PEMEX the right (i) to retain “assignments”¹⁵, or entitlements to certain areas, that were producing as of December 21, 2013 (needs to submit development plan) and (ii) to retain for three years (with a possible two-year extension, subject to a pre-established exploration plan) assignments in areas where PEMEX had made commercial discoveries or exploratory investments as of December 21, 2013.¹⁶ Within 180 days of the filing of PEMEX’s requests for assignments (i.e., by September 17, 2014), the Ministry of Energy must issue a resolution regarding PEMEX’s area request. In this resolution, the Ministry of Energy, with technical assistance from the National Hydrocarbons Commission, will

assign areas to PEMEX, and also set the surface area, depth and duration of each entitlement granted to PEMEX.¹⁷

The areas not requested by (or not granted to) PEMEX will be subject to future bid rounds. In areas retained by PEMEX, the reform provides that PEMEX may request the “migration” (or conversion) of an entitlement into a risk-sharing upstream contract.¹⁸ The reform provides that upon a migration, if PEMEX wishes to enter into contracts with private parties to develop the converted areas, the National Hydrocarbons Commission is to conduct a bidding process to select the private party partner. In addition, the Ministry of Energy is to establish the technical and contractual guidelines and the Ministry of Finance is to establish the fiscal terms and economic conditions of the relationship.¹⁹

Booking of Reserves.

The booking of reserves is an important financial reporting practice that allows oil and gas companies to reflect the volume of reserves they have the right to produce and market.

The reform establishes that private parties and PEMEX may “report for accounting and financial purposes, assignments and corresponding contract and expected benefits” as long as the assignments or contracts establish that, until produced, title to all hydrocarbons in the ground resides exclusively with the State.²⁰ Based on the foregoing, private parties would not be prevented from “booking reserves” subject to applicable securities laws. Under international practice, subject to the rules of the pertinent reporting jurisdiction, international oil companies can show volumes of reserves in their public financial statements even if they do not have legal title to the hydrocarbons in place.

Indeed, under most contracts around the world, oil and gas companies do not “own” the reserves in place but are nonetheless permitted to book them.

The Mexican Petroleum Fund.

The reform creates a new entity, the Mexican Petroleum Fund (*Fondo Mexicano del Petróleo para la Estabilización y el Desarrollo*), a public trust to be established by the Ministry of Finance and administered by Mexico’s central bank (*Banco de México*), as trustee.²¹ The Mexican Petroleum Fund will be entrusted with receiving, administering and distributing all

¹³ Energy Reform Bill, Transitional Article Six.

¹⁴ Energy Reform Bill, Transitional Article Six.

¹⁵ The term “asignación,” which does not have a precise English translation, refers to the administrative act by which the Mexican state essentially grants PEMEX an entitlement to develop the oil and gas resources in a particular area.

¹⁶ Energy Reform Bill, Transitional Article Six.

¹⁷ Id.

¹⁸ Id.

¹⁹ Energy Reform Bill, Transitional Article Six.

²⁰ Energy Reform Bill, Transitional Article Five.

²¹ Energy Reform Bill, Transitional Article Fourteen.

government oil revenues, with the exception of taxes paid by oil companies.²² Modeled after Norway's sovereign natural resources fund, the Mexican Petroleum Fund will invest part of the revenue from petroleum exploration and production into long-term savings vehicles and pension funds.²³ It will be controlled by a technical committee comprised of three representatives from the government and two independent members appointed by the President and approved by two-thirds of the Senate.²⁴ The Mexican Oil Fund is set to become operational starting in 2015.

Seismic Data and Permits.

In addition to its other duties, the National Hydrocarbons Commission is charged with establishing and administering the National Hydrocarbons Information Center (*Centro Nacional de Información de Hidrocarburos*), which will serve as a repository for geologic and seismic information.²⁵ The National Hydrocarbons Commission is reportedly planning to make seismic data available that has been collected by PEMEX over the course of the past few decades. In addition, the National Hydrocarbons Commission has stated it intends to grant "seismic permits" as early as June 2014 to allow commercial seismic companies to gather and sell proprietary data for a specified number of years, after which the data would be made publicly available.

II. Midstream and Downstream Sectors

The reform ends PEMEX's monopoly and opens the midstream and downstream sectors to private investment and competition. Under the new framework, the Energy Regulatory Commission (*Comisión Reguladora de Energía*) will be in charge of granting permits for the storage, transportation and distribution of hydrocarbons, and regulating firsthand sales of fuels.²⁶ The Ministry of Energy will be in charge of regulating firsthand sales and granting permits to private companies for the storage, transportation and distribution of hydrocarbons.²⁷

The reform also provides that, within 12 months of the effective date of the new Regulatory Law of Article 27, the executive branch must establish by decree the National Center of Natural Gas Control (*Centro Nacional de Control del Gas Natural*)

to oversee the operation of the national pipeline network.²⁸

III. Electric Power Sector

The reform will also open the electric generation sector to full private participation and investment. The amendment to Article 28 of the Constitution removes the classification of power generation as a public service activity that is reserved exclusively to the state, thus permitting private investment and competition in power generation.²⁹ This change represents a fundamental departure from the previous regime under which private parties could only participate in limited power generation activities.

The Energy Regulatory Commission is charged with granting permits for generation, and regulating the tariffs to be paid by CFE for transmission and distribution services.³⁰

Electricity transmission and distribution, as well as the planning and control of the national electric grid, will remain public service activities reserved exclusively to the state.³¹ The reform does, however, permit state entities to enter into agreements with private parties to perform those services.³²

In addition, the reform provides that, within 12 months of the enactment of secondary legislation governing the electric power sector, the executive branch must create the National Center of Energy Control (*Centro Nacional de Control de la Energía*), which will operate the national electricity network, administer the wholesale electricity market, and ensure open access to the transmission grid and distribution systems.³³

IV. Changes to PEMEX and CFE

The reform calls for the conversion of PEMEX and CFE into so-called "productive state enterprises" (*empresas productivas del Estado*), which would continue to be State-owned companies.³⁴ As productive state enterprises, PEMEX's and CFE's main objectives going forward will be "creating economic value and increasing the Nation's revenue, following the principles of equity, and social and environmental responsibility."³⁵ As productive state enterprises, PEMEX and CFE will have increased budgetary autonomy and are permitted to set their

²² Id.

²³ Id.

²⁴ Id.

²⁵ Energy Reform Bill, Transitional Article Twelve(c).

²⁶ Energy Reform Bill, Transitional Article Ten(c).

²⁷ Energy Reform Bill, Transitional Article Sixteen(a).

²⁸ Id.

²⁹ Constitución Política de los Estados Unidos Mexicanos, as amended, Art. 28 (post-reform), Diario Oficial de la Federación [DO], 5 de Febrero de 1917 Mex.).

³⁰ Energy Reform Bill, Transitional Article Ten(c).

³¹ Constitución Política de los Estados Unidos Mexicanos, as amended, Art. 28 (post-reform), Diario Oficial de la Federación [DO], 5 de Febrero de 1917 (Mex.).

³² Id.

³³ Energy Reform Bill, Transitional Article Sixteen(b).

³⁴ Energy Reform Bill, Transitional Article Twenty.

³⁵ Energy Reform Bill, Transitional Article Twenty (I).

own operating budgets subject to two conditions: (i) PEMEX and CFE operate with a balanced budget and (ii) PEMEX and CFE comply with the ceiling on personal services to be proposed by the Ministry of Finance and approved by the Congress.³⁶ As part of the conversion process, PEMEX and CFE are to adopt industry best practices in terms of their organization, administration and corporate structures.³⁷ Each company will also have a new board of directors appointed by the President, composed of five independent members and five members of the federal government, with the Secretary of Energy presiding over both boards.³⁸ Among other things, the reform removes the representatives of the petroleum workers' union from the board.³⁹

Conclusion

The reform comes at a pivotal time for Mexico. The country currently faces a production crisis. Over the past decade, crude

oil production has declined rapidly, dropping from a peak of 3.4 million barrels per day (bpd) in 2004 to 2.5 million bpd in 2012 (even as capital investment has increased to \$26 billion in 2013 from \$4.8 billion in 2001). Mexico has become a net importer of refined petroleum products and natural gas, and is on its way to becoming a net importer of crude oil by the end of the decade without significant and comprehensive reform.

With the reform, Mexico is well positioned to reverse this trend. The reform bill's transitional articles establish a clear and precise roadmap of the steps ahead, including the content of secondary legislation and creation of key regulatory agencies. Nonetheless, many questions remain to be answered in secondary legislation. The Mexican Congress will need to strike the right balance in the secondary laws in order to attract the private capital, technology and expertise needed to develop the country's abundant energy resources.

³⁶ Energy Reform Bill, Transitional Article Twenty (II).

³⁷ Energy Reform Bill, Transitional Article Twenty (III).

³⁸ Energy Reform Bill, Transitional Article Twenty (IV).

³⁹ Previously, the Petroleum Workers' Union held 5 of 15 seats on the PEMEX Board of Directors.

For updated information regarding the Mexican energy reform, including the upcoming secondary legislation implementing the reform, please visit: <http://www.mayerbrown.com/mexico-energy-reform/>

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