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MEXICO'S REVOLUTIONARY ENERGY REFORM: SIX TAKEAWAYS

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Near the end of 2013, Mexican President Enrique Peña Nieto signed into law a sweeping constitutional reform that opened the Mexican energy industry to private sector investment and competition.² In August 2014, the Mexican Congress passed and President Peña Nieto signed key legislation implementing the constitutional reform and detailing the new legal regime that will govern private sector investment and participation in the country's energy industry.³ More recently, the Secretary of Energy (SENER) announced the results of the Round Zero process, a special bidding round in which Petróleos Mexicanos (Pemex), the national oil company, requested and was granted exploration and development rights to much of the country's known oil and gas reserves.

This article highlights six key features of the reform that we believe will significantly impact upstream oil and gas activity and investment in Mexico.

I. Ends the Pemex monopoly and opens the upstream oil and gas sector to private investment and competition.

Prior to the constitutional reform, Mexico had one of the most restrictive legal frameworks for oil and gas development and production in the world. For over 75 years, Pemex has held a constitutionally protected monopoly over every step of the petroleum value chain in Mexico, from exploration and production to refining to distribution, storage and marketing. Article 27 of the Mexican Constitution provided that, regarding 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 corresponding Regulatory Law [of Article 27].” Similarly, Article 28 classified hydrocarbons and basic petrochemicals as “strategic areas” reserved exclusively to the Mexican government, rendering Pemex, a state-owned entity, exempt from Mexico's anti-trust and competition laws. These constitutional provisions, along with two federal statutes—the Regulatory Law of Article 27 of the Constitution (*Ley Reglamentaria del Artículo 27 Constitucional en el Ramo del Petróleo*), and the Pemex Law (*Ley de Petróleos Mexicanos*)—have given Pemex a monopoly over nearly every aspect of the hydrocarbons industry.⁴

The reform removes these constitutional constraints by allowing private parties to participate in Mexico's upstream oil and gas industry through the granting of exploration and production (E&P) contracts or joint ventures with Pemex. While the reform makes many sweeping changes to Mexico's existing legal framework, Pemex will remain state-owned and the Mexican government will continue to hold title to all oil, gas and mineral deposits within its national boundaries.

II. Introduces a new contractual framework in which private parties can be awarded E&P contracts (licenses, production-sharing contracts and profit-sharing contracts).

The reform establishes a new contractual framework for exploration and production in Mexico. Prior to the reform, Mexican law prohibited the government from granting private parties contract rights to develop oil and gas resources within the country (as discussed in the next

section, Mexican law also limited Pemex's ability to enter into agreements with international oil and gas companies to develop those resources). The reform repeals these and other restrictions on private sector participation in the upstream oil and gas industry and permits the Mexican government to grant contract exploration and production (E&P) rights directly to private parties.

The newly enacted Hydrocarbons Law and Hydrocarbons Revenues Law establish a new legal framework that will provide for four types of contractual models: (i) licenses; (ii) production-sharing contracts; (iii) profit-sharing contracts; and (iv) pure service contracts. Starting with Round One, the first bid round that will be open to private parties in decades, E&P contracts are to be granted through a competitive bidding process. The draft bid terms and conditions for Round One are expected to be published in November of 2014 and the tender process is expected to commence in the first quarter of 2015 with awards expected in May 2015.

Under the constitutional reform and the Hydrocarbons Law:

- the SENER is charged with selecting areas for public bidding and establishing the technical and financial qualifications for bidders;
- the National Hydrocarbons Commission (CNH) is charged with conducting the bidding process, evaluating bids and awarding contracts; and
- the Secretary of Finance is charged with establishing the economic and fiscal terms of the E&P contracts.

Under the Hydrocarbons Revenues Law, E&P contracts will provide for the following payments by the contractor to the government:

- monthly exploratory phase fees;
- royalties; and
- a payment that consists of a percentage of the contract value of hydrocarbons produced (licenses) or a payment that consists of a percentage of operating profits (production-sharing and profit-sharing contracts).

In addition, license agreements will include a signing bonus, which will be a one-time payment to be determined by the Ministry of Finance on a contract-by-contract basis.

Royalty payments will be determined based on the "contract value" of produced hydrocarbons, which is calculated by multiplying the volume of production by its "contract price." The contract price for each type of hydrocarbon is its market price in US dollars, as adjusted pursuant to a mechanism to be set forth in each E&P contract. The mechanism will take into account the hydrocarbon's quality, API gravity, marketing, and transportation and logistical costs, among other factors.

In addition, the contractor may be subject to minimum investment requirements or work programs that were committed to during the bidding process. The contractor may take and own the hydrocarbons in-kind at the wellhead. All of the above payments will be paid in cash by the

contractor. These payments are in addition to any taxes owed by the contractor pursuant to the Mexican Income Tax Law or other tax laws.

III. Allows joint ventures with Pemex.

Prior to the reform, payments by Pemex to private companies under service contracts were restricted to fixed-fee payments; in-kind payments and other forms of production and profit sharing were prohibited. Consequently, a private company could not own production, share in the proceeds from the sale of production, or share in the profits from a joint venture with Pemex. Due to this restrictive framework, there has been limited private investment and participation in Mexico's oil and gas industry over the past 76 years.

On March 21, 2014, PEMEX submitted its Round Zero request to the SENER, requesting to retain the following:

- 100% of PEMEX's producing areas;
- 83% of Mexico's proven and probable reserves (2P Reserves); and
- 31% of Mexico's prospective resources.

On August 13, 2014, the SENER announced that PEMEX will be granted all of the requested producing and 2P reserves, and 21% of Mexico's prospective resources (instead of the 31% requested).

Pemex may request that any of these Round Zero entitlements be "migrated" into an E&P contract. Round Zero entitlements that are converted into E&P contracts will be subject to the same rules and regulations as other upstream contracts granted to private companies. After such migration, Pemex can enter into contracts or joint ventures with private parties to develop the migrated areas. In that event, the CNH would conduct a bidding process to select the private party (and Pemex may only voice its opinion), the Ministry of Energy will establish the technical and contractual guidelines, and the Ministry of Finance will establish the fiscal terms.

Separately, Pemex may participate in tender processes for E&P contracts (after Round Zero) and may freely enter into joint ventures with private parties to participate in those tender processes. When Pemex is granted an E&P contract in a competitive tender process, Pemex, like any other private party, will be allowed to assign part or all of its rights and obligations under such E&P contract to another party in accordance with the provisions of the Hydrocarbons Law and the corresponding E&P contract.

IV. Opens midstream and downstream to private sector participation.

Prior to the reform, Article 28 of the Mexican Constitution provided that "oil and other hydrocarbons" and the "basic petrochemical industry" were "strategic areas" reserved exclusively to the State and, therefore, Pemex's near-monopoly over the midstream and downstream sectors was not subject to Article 28's anti-trust and competition provisions. The reform's amendment to Article 28 ends Pemex's long-standing monopoly over most aspects of

Mexico's midstream and downstream sectors and paves the way for private investment and competition.

Under the new framework, the Energy Regulatory Commission, in consultation with the Federal Economic Competition Commission, is to establish regulations to promote a competitive energy sector. This may include the strict legal separation (or the administrative, operational or accounting separation) of certain midstream activities. The Energy Regulatory Commission will also be responsible for granting permits to private companies for the storage, transportation and distribution of hydrocarbons and for regulating firsthand sales. All permit holders providing transportation, distribution or storage services are to provide open and non-discriminatory access to their facilities, subject to available capacity and pursuant to rules to be issued by the Energy Regulatory Commission.

The SENER, on the other hand, will be responsible for regulating firsthand sales and granting permits to private companies for permits for refining and natural gas processing facilities.

The Hydrocarbons Law calls for the creation of a new independent entity to encourage the growth of and oversee the national pipeline network. The new entity will be called the "National Center of Natural Gas Control" (CENAGAS). It is to be established within twelve months after the enactment of the Hydrocarbons Law, or by August 12, 2015.

The Hydrocarbons Law contemplates the existence of interconnected transmission and storage systems that will have their own separate and independent administrators in addition to, and separate from, the National System for the Integrated Transportation and Storage of Natural Gas.

The Energy Regulatory Commission is to begin granting permits to private parties for the retail sale of gasoline and diesel starting on January 1, 2016 and gasoline and diesel fuel import permits beginning January 1, 2017, if not before. The reforms will also transition the control of gasoline and diesel prices from the government to the open market over a three-and-a-half year period. Through the end of 2014, gasoline and diesel retail prices will be subject to the current regulations. Beginning January 1, 2015 through December 31, 2017, however, gasoline and diesel prices are to be established by the Executive Branch, which is to take into account transportation cost differences between regions and other factors. Then, beginning January 1, 2018, retail prices for gasoline and diesel are to be freely determined by market conditions.

V. Ends the ban on the "booking of reserves."

The "booking of reserves" is an important financial reporting practice that allows oil and gas companies to reflect the volume and discounted value of reserves they have the right to produce and market. Previously, Mexican law had prohibited the booking of reserves. The reform expressly allows private parties (and Pemex) to "report for accounting and financial purposes, assignments and corresponding contracts and expected benefits" as long as the assignments or contracts establish that, until produced, legal title to all hydrocarbons in the ground resides exclusively with the Mexican government.

VI. E&P Companies will be subject to Local Content Requirements.

The minimum average local content requirement for E&P activities will be 25% by 2015 and will be gradually increased to 35% by 2025. Deepwater and ultra-deep-water activities may have a lower requirement, as determined by the Ministry of Economy.

The specific percentage of national content required will be established in the bidding terms of individual E&P contracts. The Ministry of Economy is required to establish the measurement methodology for national content requirements in entitlements and E&P contracts that takes into account the following factors:

- the goods and services to be contracted, considering their place of origin;
- the qualified local work;
- the investment in local and regional infrastructure; and
- the transfer of technology.

The entitlements and E&P contracts will include specific penalties for the failure to comply with the national content requirements.

ENDNOTES

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² Decreto por el que se reforman y adicionan diversas disposiciones de la Constitución Política de los Estados Unidos Mexicanos, en Materia de Energía [Decree that amends different provisions of the Political Constitution of the United Mexican States in energy matters], Diario Oficial de la Federación [DO], 20 de Diciembre de 2013, transitional arts. 4, 7, 9, 10, 11, 13, 18, 20, and 21 (Mex.). For a in-depth analysis of the constitutional energy reform and what it could mean for Mexico's upstream, midstream and downstream oil and gas and electric power sectors, see Gabriel Salinas and John D. Furlow, *Mexico's Revolutionary Energy Reform: Charting the New Frontier*, 9 TEX. J. OIL, GAS & ENERGY L. 413 (2014).

³ See, e.g., Ley de Hidrocarburos [Hydrocarbons Law], Diario Oficial de la Federación [DO], 12 de Agosto de 2014 (Mex.); Ley de Ingresos Sobre Hidrocarburos [Hydrocarbon Revenues Law], Diario Oficial de la Federación [DO], 12 de Agosto de 2014 (Mex.);

⁴ 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.).

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