

Mexico's President Unveils Historic Proposal to Open the Country's Energy Sector to Private Investment

On August 12, 2013, Mexican President Enrique Peña Nieto of the current ruling party, the *Partido Revolucionario Institucional* (PRI), delivered a highly anticipated constitutional energy reform proposal to the Mexican Senate, which, if passed, will constitute the most significant overhaul of the Mexican energy sector since 1938. The proposal is expected to be considered by the Mexican Congress in September.

Peña Nieto's announcement comes on the heels of a separate reform proposal by the country's center-right party, *Partido Acción Nacional* (PAN), which was announced on July 31, 2013. For a detailed description and analysis of the PAN's proposal, see our Legal Update, "Sweeping Mexico Energy Reform Proposal."¹

Overview of Peña Nieto's Reform Proposal

Peña Nieto is proposing broad constitutional changes that would open the Mexican petroleum industry to private participation and investment, including by international oil companies (IOCs), to explore for, and produce, oil and gas. The proposed constitutional changes would also open the midstream and downstream petroleum sectors and the electric power generation sector to private participation and investment. The key points of Peña Nieto's proposal are as follows:

- Vests in the Congress broad authority to designate those that may carry out oil and gas exploration and production activities in the country and to specify by what terms and under what conditions. The proposal includes no requirement that the national oil company, *Petróleos Mexicanos* (Pemex), maintain its monopoly on exploration and production. Private companies may be granted exploration and production rights directly by the State or under some form of association with Pemex;
- Allows private companies to own oil and gas production and to fully share in the economic risks and benefits of the business;
- Allows for direct private investment and participation in the midstream and downstream sectors, including refining, petrochemical production, distribution and the retail marketing of petroleum and refined products; and
- Reduces the domination by *Comisión Federal de Electricidad* (CFE), the national electricity utility, of the country's electricity generation, and opens the door to a competitive wholesale power market.

Currently, Mexico has one of the most restrictive legal frameworks for energy development in the world. The Mexican Constitution and the Regulatory Law, a statute governing the petroleum industry, severely restrict the role that private companies can play in the Mexican petroleum industry. Indeed, Pemex currently has a monopoly over every step of the petroleum

value chain, from production and refining to distribution and marketing.

The government also controls the electric power industry sector through CFE, which dominates the country's electric power generation and maintains a monopoly over its transmission and distribution.

Peña Nieto's proposal calls for specific constitutional changes but leaves many of the details of the broader overhaul to secondary legislation. While the proposed constitutional changes offer little guidance on how the industry will operate after the reforms, the proposal's introductory "statement of intent" (*exposición de motivos*) provides key insights into Peña Nieto's overall vision for liberalizing the Mexican energy industry. The statement of intent characterizes the proposals as a modern-day return to the spirit of the reforms instituted by President Lázaro Cárdenas at the time he expropriated and nationalized the Mexican petroleum industry in 1938. The statement of intent emphasizes that Cárdenas never intended to entirely exclude private parties from the energy industry.

Mexico's Constitution, like most constitutions around the world, provides that hydrocarbons in the subsoil belong to the state. This regime remains unchanged in the Peña Nieto's proposal. Pemex will also remain state-owned and the proposal does not open the door to a privatization or to selling shares in Pemex to the public.

UPSTREAM EXPLORATION AND PRODUCTION

Peña Nieto's proposal calls for amending Articles 27 and 28 of the Mexican Constitution, which restrict the role private companies can play in oil and gas exploration and production. Article 27 of Mexico's Constitution currently provides that when it comes to extraction of hydrocarbons, "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."

The proposal seeks to amend this restriction in order to allow the government, either directly or through Pemex, to enter into contracts with private parties to explore for and produce hydrocarbons. The proposal does not address the type of contract or incentives that will be offered to private parties; rather, it leaves the specific details to secondary legislation. Specifically, the proposal provides that the "respective Regulatory Law shall determine the form in which the Nation shall exploit such resources." Thus, if the Constitution is amended, the Mexican Congress will be charged with passing subsequent legislation detailing the types of contracts that can be offered.

The statement of intent provides some guidance on Peña Nieto's view on the issue. It states that the government shall grant "efficient contracts that align the incentives of the contractors with those of the State" in exploration and production activities. It also states that "the Regulatory Law shall determine the form ... of the contracts for the exploration and extraction of hydrocarbons, which may provide for payment mechanisms in the *form of the resources that are obtained, through cash payments or equal to a percentage of the same, among others*, as it was provided in the Cárdenas reforms and observing the best practices in this area (emphasis added)."

The proposal does not expressly discuss the issue of the booking of reserves. This accounting practice, essential to IOCs, is currently banned by Article 60 of the *Petróleos Mexicanos* Law (*Ley de Petróleos Mexicanos*) and by the current model exploration and production service contracts. Peña Nieto's proposal maintains that the hydrocarbons in the subsoil are the property of the nation but, under international practice, IOCs can book reserves and show their value or quantity in their financial statements even though they do not technically own them. Indeed, companies typically do not own reserves

outside of the United States and companies can book reserves with respect to their *reasonably anticipated* production under contracts around the world.

In the United States, the US Securities and Exchange Commission (SEC) has published accounting guidelines for the booking of reserves by US reporting entities. The SEC defines “bookable proved reserves” as “the estimated quantities of crude oil, natural gas and natural gas liquids which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions” Thus, whether a company will be able to book reserves will largely depend on what rights the company has, or what its economic interest is, in the subject hydrocarbons upon extraction. Where the company participates and derives an economic interest in the hydrocarbons produced like a producer, and is exposed to technical, environmental and commercial risks like an ordinary producer, then, arguably, the operators should be permitted to book reserves under applicable SEC guidance. If the law or the applicable contract expressly prohibits operators from booking reserves, then this treatment may be entirely different.

While the proposed amendments to the Constitution do not specifically refer to the development of deepwater, ultra-deepwater or shale resources, the statement of intent does discuss the importance of developing these resources. Accordingly, the reforms will likely open the door for the participation of IOCs in both conventional and unconventional resource development in the country.

REFINING, TRANSPORTATION, STORAGE AND DISTRIBUTION

Article 27 of the Constitution does not currently ban private participation in oil and gas refining, transportation, storage and distribution—i.e., the midstream and downstream sectors. Rather,

it is the Regulatory Law, a federal statute, that bans private participation in these activities. By establishing that the nation may enter into contracts with private parties regarding “oil and solid, liquid and gas hydrocarbons,” the proposed reform is intended to open the door to private investment in all activities in the oil and gas chain, including upstream, midstream and downstream. As stated before, the specifics of these activities will largely depend on future statutory changes to the Regulatory Law and other relevant secondary laws.

The proposed amendment to Article 28 removes the “basic petrochemical industry,” as well as petroleum and electricity (as noted below), from the list of industrial activities that are reserved exclusively for the State. In its place, the proposed amendment establishes that the provisions of Article 27 shall be applicable. This change is intended to allow the opening of the refining and petrochemical industry in Mexico to private participation and investment.

The proposal’s statement of intent provides that “third parties may be able to participate in refining, transportation, storage and distribution of hydrocarbons without putting ownership of the nation’s resources at risk.” The statement of intent also provides that in regard to midstream activities, “private parties shall be able to directly participate in all of the petroleum value chain after the extraction, including the transportation, of the resources extracted from the subsoil (crude oil, natural gas and its liquids) as well as transformed products (petrochemicals and refined products), on terms established by a secondary law, and through permits granted by the Executive Branch.”

ELECTRICITY GENERATION, TRANSMISSION AND DISTRIBUTION

Peña Nieto’s proposal seeks to reduce CFE’s domination of electric power generation and to open the electric power sector as a whole to greater private participation and investment. The price of electricity for Mexican businesses is

said to be more than 25 percent higher than for their competitors in the United States—despite the subsidies inherent in CFE’s loss-making activities, which are projected to render the utility technically insolvent by next year.

Article 27 of the Constitution currently provides that generation, transmission, distribution and supply of electric power that is not for self-consumption or sale to CFE constitutes the rendering of a “public service,” and, thus, is reserved exclusively to the Nation. The proposed amendment to Article 27 removes this restriction and establishes that, although no electricity concessions may be granted, the “State may enter into contracts with individuals *on the terms established by [secondary] laws* (emphasis added).” Here again, secondary laws will determine the extent to which private parties may participate in the electricity sector.

The proposed amendment to Article 27 establishes that the State shall control the national energy network, as well as the transmission and distribution of electricity as “public services.” The proposed amendment deletes the reference to power generation included in the current formulation of that Article. Accordingly, it appears that electric power generation would not be considered a “public service,” thereby opening the door to greater participation by the private sector.

In 1992, the Public Service Law of Electric Energy (*Ley del Servicio Público de Energía Eléctrica*) and the regulations implementing it were reformed to allow for several power generation schemes that were not considered “public service.” At first, these consisted solely of independent power producers (IPPs) selling power and energy to CFE and later grew to incorporate increasing numbers of “self-supply” arrangements as well as limited numbers of small producer and cogeneration projects. Although these reforms ushered in new investment in this sector (which contributed to the improved efficiency of the Mexican electricity sector), the Mexican electric power

sector still lacks sufficient capacity and investment to meet the country’s growing industrial demand. Based on the proposed reforms, Peña Nieto appears to be opening the door to private generation participation in a competitive wholesale electric generation market.

Under the proposal, the government retains the exclusive right to conduct electric transmission and distribution activities constituting public service. Peña Nieto’s proposal would, however, appear to allow private parties to participate in service contracts to assist CFE in the transmission and distribution of electricity.

On this point, the statement of intent establishes that:

the State shall maintain title to electric and transmission services, confirming their “public service” nature. Under this constitutional framework, the transmission and distribution networks of CFE which currently provide these public services, will remain property of the State. Additionally, the proposed reform will permit that, pursuant to the terms established by the laws, CFE may enter into contracts with private parties. Thus, the State’s title with regard to these activities shall not be an obstacle for this entity to be assisted by third parties to meet its public service objectives.

Conclusions

Peña Nieto’s proposal comes at an important time for Mexico and its energy industry. Over the past eight years, crude oil production has declined rapidly, dropping from a peak of 3.4 million barrels per day (bpd) in 2004 to a total of 2.5 million bpd in 2012 (even as capital investment has increased to \$20 billion per year from \$4 billion 10 years ago). If current trends continue unabated, Mexico could be a net importer of crude oil by 2020. Peña Nieto has

said that the proposed reform could bring in billions of dollars of private investment and boost total oil production to 3 million bpd by 2018 and 3.5 million bpd by 2025.

While Peña Nieto's proposal is ambitious, it leaves many details to secondary legislation, including the soon-to-be-submitted fiscal reform. The question remains whether this secondary legislation will attract the private capital, technology and technical expertise needed to develop Mexico's abundant energy resources, particularly its deepwater, ultra-deepwater and shale resources. If the Mexican Congress strikes the right balance and the reform succeeds, then it would likely bring billions of dollars of much-needed foreign investment into Mexico's oil and gas and electric power sectors.

The overall impact of Peña Nieto's proposal is one that will require time to be assessed. Nonetheless, Peña Nieto's proposal represents a significant step toward the liberalization of the Mexican energy sector.

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Endnote

¹ Available at <http://www.mayerbrown.com/Sweeping-Mexico-Energy-Reform-Proposal-08-02-2013/>.

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