

## Sweeping Mexico Energy Reform Proposal

On July 31, 2013, *Partido Acción Nacional* (PAN), Mexico's main opposition political party, delivered a highly anticipated energy reform proposal to the Mexican Senate, which, if passed, has the potential to revolutionize the Mexican energy sector. The proposal calls for amending articles 25, 27 and 28 of the Mexican Constitution and opening the country's oil and gas and electricity sectors to private investment and competition, among other proposed reforms.

Article 27 has been a particularly problematic provision of the Mexican Constitution, restricting, together with Mexico's Regulatory Law, private participation in oil and gas activities in Mexico for more than 60 years. Currently, *Petróleos Mexicanos* (PEMEX), the national oil company, and the *Comisión Federal de Electricidad* (CFE), the national electricity company, have a monopoly over the oil and gas and electricity sectors. The proposal is expected to be considered by the Mexican Congress in September. The *Partido Revolucionario Institucional* (PRI), the current ruling party, is expected to submit its own proposal next week. The PRI and the PAN are expected to have the required consensus to amend the Constitution.

### Overview of the PAN Reform Proposal

The PAN proposal calls for an ambitious overhaul of Mexico's energy sector by opening Mexico's upstream, midstream and downstream sectors, as well as its power generation, transmission, distribution and marketing sectors to private investment. The proposal would also

empower the existing National Hydrocarbon Commission to grant concessions and contracts to private parties, and create the Mexico Oil Fund to administer the country's oil profits. Under the proposed concession regime, private parties would be able to own hydrocarbons at the wellhead after the payment of all relevant fees and taxes, which would represent a radical change in the Mexican energy regime.

The proposed reforms are only at the constitutional level, calling for the enactment of a series of secondary laws. The proposal contains an introduction with a "statement of intent" (*exposición de motivos*) explaining the reasoning behind the proposed reforms. The main changes proposed are the following:

- Open the oil and gas upstream sector to private investment and competition;
- Establish the National Hydrocarbon Commission as the grantor of E&P oil and gas concessions;
- Open the oil and gas downstream and midstream sectors to private investment and competition;
- Open the electricity sector to further private investment and competition;
- Create the Mexico Oil Fund to administer oil profits and seek to decrease the government's dependence on oil revenue;
- Provide PEMEX and CFE with more autonomy and make changes to each of their corporate governance policies; and
- Focus on sustainability and climate change.

These proposals are analyzed below.

## **1. OPENING THE OIL AND GAS UPSTREAM SECTOR TO PRIVATE INVESTMENT AND COMPETITION**

The proposal fundamentally seeks to end restrictions on private investment in the upstream, midstream and downstream sectors. In regard to upstream exploration and production, the proposal seeks to end the ban on oil and gas concessions pursuant to Article 27 of the Constitution, by providing that Mexico “shall guarantee the maximum benefit of oil profits for the country through operators that carry out exploration and production activities ....”

This proposed revision to Article 27 of the Constitution is significant because of what it adds as well as what it deletes. First, the proposed amendment establishes the maximization of the country’s profits as the main constitutional principle for oil and gas contracting. Second, the proposed amendment removes the reference to the Regulatory Law of Article 27 (*Ley Reglamentaria del Artículo 27 Constitucional en el Ramo del Petróleo*). The Regulatory Law (which goes beyond the terms of the Constitution) establishes that (1) “Petroleum Industry” activities (upstream, midstream and downstream) may only be carried out by PEMEX, (2) only PEMEX, and not private companies, may receive “assignments” of contract areas, (3) only cash consideration may be paid to exploration and production contractors, thus prohibiting payments-in-kind or profit-sharing arrangements.

The proposed amendment to Article 27 states that Mexico may develop its hydrocarbons “through operators that perform exploration and production activities in terms of [the proposed] Article 28,” which establishes a concession-based regime, as discussed in point 2 below.

It should also be noted that proposed Article 27 refers to oil or “hydrocarbons that originate from any geological formation,” thus opening the door to shale gas development (the statement of

intent establishes shale gas development as one of the main focus points of the proposed reform).

Although the proposed reform does not refer directly to the booking of reserves, which is banned by Article 60 of the PEMEX Law (*Ley de Petróleos Mexicanos*) and by the current model exploration and production service contracts, the spirit of the PAN proposal seems calculated to permit the booking of reserves while maintaining Mexico’s sovereign “ownership” of hydrocarbons in the ground before being brought to the wellhead. Indeed, the statement of intent establishes that the “registration [of reserves] shall correspond to the laws of Mexico.” It also establishes, however, that operators “shall own the oil and hydrocarbons after the payment of the fees at the wellhead in terms of the corresponding legislation.”

Although the issue of reserve booking will require further analysis, pursuant to the PAN proposal, operators may own the production after the payment of applicable fees, and thus be subject to reserve booking rights (pursuant to their home country reserve rules). If the proposed reform is passed, this issue would need to be clarified through subsequent legislation.

## **2. NATIONAL HYDROCARBON COMMISSION TO GRANT OIL AND GAS CONCESSIONS**

Article 28, as proposed, grants constitutional authority to the National Hydrocarbon Commission, establishing it as the agency in charge of regulating exploration and production activities relating to hydrocarbons. Pursuant to the proposed transitional Article 9, the National Hydrocarbon Commission would grant oil and gas concessions to operators pursuant to a law to be established by the Commission. This law would establish an “initial special proceeding” (referred to as a “Round Zero” in the statement of intent), with the purpose of granting PEMEX a “special assignment” of certain concessions, which shall give PEMEX’s “preeminence” and “preferential treatment” over the other operators in the concession assignment. This approach is

similar to the process utilized by Colombia during its energy reform a decade ago when Ecopetrol, the Colombian national oil company, was assigned certain concessions directly from the Colombian Hydrocarbon Regulatory Authority (ANH). The proposed transitional Article 9 further provides that the general granting of concessions shall be carried out through international public bids open to public and private companies, as well as public-private associations.

After this initial special proceeding, PEMEX is to compete on equal footing with the other operators, similar to the process established in Colombia and Brazil<sup>1</sup> after their energy reforms. The proposed transitional Article 4 establishes that the activities of extraction and transformation of hydrocarbons and the marketing of resulting products shall be developed “in effective competitive conditions and strict legal and operational separation with the transportation, storage and distribution activities that are in a natural monopoly condition.”

Pursuant to proposed transitional Article 10, PEMEX and other operators “shall access the concession regime for the exploration and exploitation of hydrocarbons by participating in public bids in ... through a concession scheme, which shall take into account the risks, oil prices, type of reservoir or resources, as well as the investment required, among others.”

### **3. OPENING THE OIL AND GAS DOWNSTREAM AND MIDSTREAM SECTORS TO PRIVATE INVESTMENT AND COMPETITION**

As previously stated, the proposed amendment to Article 27 removes the reference to the current Regulatory Law, which restricted hydrocarbon activity in Mexico beyond the requirements of the Mexican Constitution in at least two significant ways as it relates to the midstream and downstream sectors. First, the current Regulatory Law provides that all of the

following activities (in addition to the “exploitation” of oil—thus including all upstream activities—as the Constitution currently provides), are activities reserved exclusively to Mexico (PEMEX): refining, transportation, storage, distribution and firsthand sales of crude oil and refined products (in sum, all midstream and downstream activities). Thus, pursuant to the current Regulatory Law, private companies are prohibited from participating in upstream, midstream and downstream activities; whereas, the Constitution seem to only restrict upstream activities.

Second, as stated before, the Regulatory Law currently provides that Mexico shall carry out the upstream, midstream and downstream activities only through PEMEX, thus sanctioning the monopoly of PEMEX over all these activities.

By removing the reference to the existing Regulatory Law, the proposed reform opens the door to private investment in all upstream, midstream and downstream activities.

In addition, proposed Article 28 grants constitutional authority to the Energy Regulatory Commission, and charges it with regulating the “refining, processing, distribution, transportation and storage of oil (i.e., downstream and midstream activities), that may be carried out by Mexico (PEMEX), *independent operators*, or in a joint manner, in terms of the Constitution and the corresponding laws (emphasis added).” Finally, proposed transitional Article 11, authorizes the Energy Regulatory Commission to “grant, authorize and revoke *permits or concessions...* for the refining, processing, distribution, transportation and storage of oil and hydrocarbons pursuant to the corresponding laws (emphasis added).”

The downstream and midstream reform is a key part of the proposed energy reform since Mexico’s refining and pipeline industries are in particular in need of upgrade and expansion and thus are presently hampering Mexico’s economy.

#### 4. OPENING THE ELECTRICITY SECTOR TO FURTHER PRIVATE INVESTMENT AND COMPETITION

In 1992, the Public Service Law of Electric Energy (*Ley del Servicio Público de Energía Eléctrica*) and its regulatory law were reformed to allow for different power generation schemes that were not considered “public service,” including power generation for self-consumption, co-generation or small generation, and independent power generation to sell to CFE. These reforms ushered in new investment in this sector which contributed to the improved efficiency of the Mexican electricity sector. Yet, the Mexican electricity sector is still lacking sufficient capacity and investment to meet the country’s growing industrial demand.

Proposed Article 27 would delete the following power generation ban in the Constitution:

It exclusively corresponds to the Nation, the generation, transmission, transformation, distribution and supply of electric power that has as an objective the rendering of a public service. In this realm, no concession shall be granted to individuals and the Nation shall take advantage of the goods and natural resources required for this purpose.

Pursuant to the PAN reform proposal, this limitation would be removed. For full implementation, further legislation would need to be passed regarding CFE’s structure and the participation of new operators in the generation and marketing of electricity in Mexico.

Pursuant to the proposed reform, the Energy Regulatory Commission, in addition to regulating the midstream and downstream sectors, will also regulate Mexico’s electricity sector. Proposed Article 28 establishes that the Energy Regulatory Commission shall regulate “the generation, operative control, transmission, distribution and marketing, as well as the efficient supply and sale of electricity to be *carried out by the Nation or by individuals* (emphasis added).” Furthermore, proposed

transitional Article 11 establishes that the Energy Regulatory Commission shall “grant, authorize and revoke *permits or concessions* ... for the generation and distribution of electricity generated by individuals ... (emphasis added).” Thus, the generation, transmission, distribution and marketing of electricity would be opened to private investment pursuant to the Constitution, although secondary laws would clearly need to be enacted.

The reform also provides that CFE shall compete on equal footing with other operators. The proposed transitional Article 4 establishes that the activities of electricity generation and marketing shall be developed “in effective competitive conditions and strict legal and operational separation with the transportation, storage and distribution activities that are in a natural monopoly condition.”

Of particular note, the proposed reform does not modify the current ban on the granting of concession or permits regarding the use radioactive materials and nuclear power, which are activities exclusively reserved to the country, thus excluding private investment in nuclear power in Mexico.

#### 5. MEXICO OIL FUND TO ADMINISTER OIL PROFITS AND SEEK TO DECREASE GOVERNMENT’S DEPENDENCE ON OIL REVENUE

The proposed amendment to Article 28 also creates the Mexico Oil Fund, an independent constitutional body charged with administering (and maximizing) the country’s oil profits. This Fund would receive the “fees” to be paid by operators. The amount of the fee shall depend on the “risk, oil prices, type of reservoir and resources, as well as the investment needed.” Thus, the Mexico Oil Fund, in theory, would be able to use its ability to set fees as a market driver to attract investments where needed.

Proposed transitional Article 7 establishes that the Chamber of Deputies (*Camara de Diputados*) of the Mexican Congress shall

determine how much of the Fund revenue shall be allocated to the federal budget, with the long-term goal of gradually decreasing the overall amount allocated to federal budget. In addition, the President is tasked with “decreasing the fiscal dependence on oil resources and reducing PEMEX’s labor liabilities” over a 10-year transition period.

The Mexico Oil Fund shall be integrated by the President of Mexico and a Governing Board (*Junta de Gobierno*) to be proposed by the President with approval of the Senate. One year after the enactment of the proposal, the Congress is to enact a law establishing the Fund’s internal structure, membership of the Board and a Chairman, and other matters.

The statement of intent discusses at length the purpose of the Fund, referring to other jurisdictions, particularly Norway, that have sovereign funds that administrate and invest their natural resource wealth.

## 6. PEMEX AND CFE AUTONOMY AND CORPORATE GOVERNANCE CHANGES

The proposed reform also seeks to provide PEMEX and CFE with more autonomy and stronger corporate governance. Proposed transitional Article 5 establishes that both PEMEX and CFE remain state owned; however, PEMEX and CFE each shall have the “operational autonomy to determine its best structure and they shall not form part of the Federal Budget.” The Ministry of Finance (*Secretaria de Hacienda*) shall approve their financial ceilings and capitalization levels. Furthermore, pursuant to proposed transitional Article 6, the management and planning of PEMEX and CFE shall be the responsibility of their Boards of Directors, which shall follow international practices of corporate governance. The Board of each entity shall be comprised of five independent members, four government members and the Minister of Energy as a chairman with the ability to cast votes. The proposed Board structure notably excludes

representation from the PEMEX and CFE unions, which is likely to become a controversial issue. The chief executive officers of each entity will be selected by its Board. In addition, as previously mentioned, the President is tasked with reducing PEMEX’s labor liabilities within a 10-year transition period.

## 7. FOCUS ON SUSTAINABILITY AND CLIMATE CHANGE

Both the reform proposal and the statement of intent emphasize the importance of sustainability and adopting climate change policies. In particular, proposed Article 25 establishes that Mexico shall ensure that energy development is conducted “with low emissions of gas and greenhouse gasses.” In addition, proposed Article 27 establishes that in order to ensure the efficient use of the energy resources, Mexico shall develop strategies and integral programs to mitigate and adapt to climate change. The proposed reform repeatedly refers to “efficient” and “sustainable” activities related to the productivity, public works, industrial development, etc. Of particular note, the proposed reform does not address security issues and environmental contingencies, which are not only relevant to Mexico but also to the United States.

## Conclusion

The PAN proposal seeks to enact the most important energy reform in Mexico in the last 60 years. Although the PRI is expected to deliver its own energy reform proposal next week, both the PAN and the PRI favor market-friendly energy policies, making major changes in the Mexican petroleum regime a real possibility.

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**Endnote**

<sup>1</sup> Brazil has recently retreated somewhat from this position in the bid rounds relating to the Pre-Salt areas, where participating operators are required to contract with Petrobras, the Brazilian national oil company.

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