

Sweeping Reforms Expected to Revolutionize Mexico's Energy Sector

The Mexican Congress and a majority of Mexican states have passed a historic energy reform bill that will open Mexico's energy industry to private investment and competition. President Enrique Peña Nieto is expected to publish the law in the *Diario Oficial de Federacion* on December 20, 2013. Once published, the reform bill will come into force the next day.

The reform eliminates a restrictive legal framework that has limited private investment and participation in the country's energy industry for more than 75 years. The reform includes amendments to articles 25, 27 and 28 of the Mexican Constitution and transitional articles that detail how the Congress and the executive are to implement the constitutional changes. In short, the reform will:

- Open 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 licenses or contracts either directly by the government or in association with PEMEX;
- Give PEMEX the opportunity to retain acreage that it already has under production or that it is actively exploring in a "Round Zero";
- Allow private parties to book reserves;
- Open the oil and gas downstream and midstream sectors to private investment and competition;
- Create 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);
- Introduce corporate governance changes and more financial independence to PEMEX and CFE; and
- Create the Mexico Oil Fund, a sovereign natural resources fund, to administer, distribute and invest the country's oil revenues.

Full implementation of the reform will require the Mexican Congress to pass additional so-called "secondary laws" that would 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. The reform is a product of the efforts of Mexico's two main political parties, the *Partido Revolucionario Institucional*, or "PRI", and the *Partido Acción Nacional*, or "PAN".

Upstream Oil and Gas Sector

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.*" Similarly, prior to the reform, Article 28 of the Constitution provided that hydrocarbons and basic petrochemicals were "strategic areas" reserved exclusively to the state. 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. This framework even restricted the consideration payable by PEMEX to private companies under E&P service contracts, prohibiting payments in kind or otherwise sharing in production, and prohibiting any form of sharing or allocation of sales proceeds or profits. A private company, therefore, could not own production, share in the proceeds from the sale thereof, or share in the profits from the project. Not surprisingly, there has been no meaningful private investment or participation in Mexico's oil and gas industry for decades. The reform's amendment to 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 either to PEMEX or to private parties. The amendment also allows PEMEX to enter into joint ventures and contracts with private companies to exploit the areas retained in Round Zero.

New Contract Framework. With the repeal of these restrictions, the reform law contemplates establishing a new contractual framework to govern upstream oil and gas

exploration and production. The law provides that "maximizing the Nation's revenues" is to be the state's guiding principle in implementing this framework. The law also 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 contracts is not exclusive and that those contract types named in the article are "among others" available for use by the state in developing the country's oil and gas resources. Essentially, the new provision establishes that Congress is not limited to choosing between licenses, production-sharing, profit-sharing and service contracts but has the flexibility to choose among a broad range of 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 reform law.

Under the reform, the Ministry of Energy is charged with granting oil and gas rights, selecting areas for public bidding, establishing the technical and financial requirements for bidders and awarding contracts (with technical assistance from the National Hydrocarbon Commission). The law also creates a new independent agency, the 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*) to regulate and oversee certain aspects of oil and gas operations principally in regard to protection of the environment.

Round Zero. Before giving private companies the opportunity to bid for certain areas, the reform establishes that there is to be a "Round Zero," during which PEMEX will have the

opportunity to retain acreage that it already has under production or that it is actively exploring. After this initial round, PEMEX is to compete on an equal footing with other operators in obtaining additional contract areas, similar to the process established in Colombia and Brazil after the energy reforms in those countries.

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 new law does not restrict the booking of reserves, and specifically establishes that private parties may “report for accounting and financial purposes, the corresponding assignment or contract and their expected benefits” with the understanding that while the hydrocarbons remain in the subsoil, ownership thereof resides exclusively with the state. 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. Prior to the reform, this practice was banned by Article 60 of the PEMEX Law (*Ley de Petróleos Mexicanos*) as well as by PEMEX’s model exploration and production service contracts.

The Mexico Oil Fund. The reform creates a new entity, the Mexican Oil Fund (*Fondo Mexicano del Petróleo para la Estabilización y el Desarrollo*), a public trust to be administered by Mexico’s central bank (*Banco de México*), as trustee. The Mexican Oil Fund will be entrusted with receiving, administering and distributing all government oil revenues, with the exception of taxes paid by oil companies. Modeled after Norway’s sovereign natural resources fund, the Mexico Oil Fund will invest part of the oil income into long-term savings vehicles and pension funds. 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.

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. The Ministry of Energy will be in charge of granting permits for refining and natural gas processing facilities. Moreover, the reform law provides that, within 12 months of its enactment, the executive branch must establish the National Center of Natural Gas Control (*Centro Nacional de Control del Gas Natural*) to oversee the operation of the national pipeline network.

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. This change represents a fundamental departure from the previous regime under which private parties could only participate in limited power generation activities. Nonetheless, 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. The reform does, however, permit state entities to enter into agreements with private parties to perform those services. In addition, the reform provides that, within 12

months of its enactment, 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.

Changes to PEMEX and CFE

The law also seeks to convert PEMEX and CFE into “productive” state-owned companies that would compete in the marketplace. Under the law, PEMEX and CFE’s main objective going forward will be “creating economic value and increasing the Nation’s revenue, following the principles of equity, and social and environmental responsibility.” Their budgets will be proposed by the Ministry of Finance and approved by Congress. PEMEX and CFE are to adopt industry best practices in terms of their organization, administration and corporate structures. 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. Among other things, this change removes the right of the PEMEX workers union to representation the PEMEX board.

Looking Ahead

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 many feared that the country would also become a net importer of crude oil by the end of the decade without significant and comprehensive reform. The problem for Mexico has never been a lack of oil and gas in the

ground. Rather, the problem has been that the country has had one of the world’s most restrictive legal frameworks for energy development and production. The legal framework, combined with rigid legal, financial and regulatory constraints placed on PEMEX, has resulted in limited investment in exploration outside of the country’s (now mature) onshore oil fields and the massive Cantarell oil field in the shallow waters of the Gulf of Mexico.

With the reform, Mexico is well-positioned to turn this situation around. The transitional articles of the constitutional amendments (which were heavily negotiated by the PAN) establish a clear and precise roadmap of the steps ahead, including the content of secondary legislation and creation of key regulatory agencies. Some major issues were left to be answered by Congress in secondary legislation, and Congress will need to strike the right balance when addressing these issues in order to make the reform a success and attract the private capital, technology and expertise needed to develop the country’s abundant energy resources, particularly its deepwater and shale resources. Because the Congress which enacted the reforms will be the Congress to enact the enabling legislation, the expectation is that sensible market favorable legislation will ensue.

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