

Mexican Energy Reform: A step forward

by David Jiménez¹

On October 28, 2008 the Mexican Congress passed a bill to amend and create several federal laws and statutes related with the energy industry. The bill of amendments and of new laws (the “Energy Reform”) was voted affirmatively and passed by the Congress and will be further enacted through its publication in the Federal Register. It is expected that the Energy Reform will foster private participation in the energy sector and bring business opportunities for both domestic and international companies dealing with Pemex, the Mexican state-owned oil company. The Energy Reform also includes the enactment of new laws related to the development of renewable sources and clean energies that will certainly foster development of private power generation projects and energy efficiency in Mexico.

This article provides an overview of (i) the current legal framework applicable to both the oil & gas and power industries in Mexico and (ii) the most important features of the recently passed Energy Reform.

Oil & Gas current Legal Framework

The Mexican Constitution reserves the ownership and exploitation of domestic hydrocarbons to the Mexican State. Pursuant to the Petroleum Regulatory Law (*Ley Reglamentaria del Artículo 27 Constitucional en el Ramo del Petróleo*), as amended by the Energy Reform, except in the case of midstream and downstream natural gas industry and coal-bed methane, the exploration, production, refining, storage, transport, and first-hand sales (*ventas de primera mano*) of domestic hydrocarbons, by-products and basic petrochemicals - known as the “strategic activities” - are exclusively reserved to the Mexican State. Accordingly, no concessions may be granted to private parties to explore and produce hydrocarbons in Mexico. This vertically-integrated monopoly established by statutory law and not by the Constitution, has been legally and exclusively entrusted to *Petróleos Mexicanos* and its subsidiaries (“Pemex”). Exploration, production and refining of oil and gas as well as production of basic petrochemicals² in Mexico are, thus, conducted exclusively by Pemex. In addition, it is clear from the Petroleum Regulatory Law that Pemex is barred to enter into risk agreements or to agree profits share or payment in kind of oil and gas.

Pursuant to the Petroleum Regulatory Law, the Pemex monopoly is only with respect to the development of domestic hydrocarbons as an industrial chain. Likewise, the Pemex monopoly should end whenever Pemex undertakes the first sale (*venta de primera mano*) of the relevant hydrocarbon, by-product or basic petrochemical; all of the activities thereafter should be within the stream of commerce with no restrictions as to the ability to participate in such activities (except for certain foreign investment limitation in LPG and fuels retail).

Pemex is subject to mandatory statutes and regulations aimed at regulating its activities as a public instrumentality of the federal government of Mexico, known as the “parastatal” regime, which regime is cumulatively applicable to Pemex with all other commercial and civil laws and regulations generally applicable to companies in Mexico.

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² Ethane, propane, butane, pentane, hexane, heptane, carbon black raw material, naphtha, and methane.

Exploration & Production

Exploration and production of hydrocarbons within the Mexican territory is conducted exclusively by Pemex. Likewise, Pemex is entitled to explore and exploit on-shore and off-shore cross-border reservoirs (*yacimientos transfronterizos*) in accordance with international treaties entered into by Mexico. For the above-mentioned purposes, Pemex is allowed to enter into works and services agreements with private parties, in the understanding that risk and share production agreements as well as payment in kind of oil and gas are prohibited. Awarding of works and service contracts with Pemex is made through public bid as a general rule.

In recent years Pemex launched the so-called “multiple services contracts” (MSC), pursuant to which a private company or a consortium of private companies provides several services (including oilfield services) to develop and operate non-associated gas in a specific area under the control and supervision by Pemex. Such services are contracted under a “fee for service” arrangement; the MSC are not a concession, lease, joint venture, production sharing contract, or risk sharing contract. Furthermore, Pemex released the so-called “alliance contracts” for the rendering of services for the optimization and development of marginal oil fields for the production of oil.

Refining

Refining of domestic hydrocarbons within Mexico has been exclusively reserved to Pemex, and comprises the refining of Mexican hydrocarbons, foreign hydrocarbons, and the mix of both. Refining includes the industrial processes transforming hydrocarbons to the following generic products: (i) liquid and gaseous fuels; (ii) lubricants; (iii) oil; (iv) paraffin; (v) asphalts; (vi) solvents, and (vii) by-products generated from such processes.

As regards fuels, Pemex carries out the first-hand sales of gasoline and diesel to private retailers. Although fuels retail is not within the Pemex exclusivity, Pemex is the only fuels supplier in Mexico. Likewise, only Mexicans (individuals or companies without any foreign participation) are permitted to conduct fuels retail through a Pemex franchise, except by means of “neutral investment” granting the foreign investor economic rights but limited corporate rights.

Gas and Basic Petrochemicals

Exploration, production, processing, and first-hand sales of natural gas, as well as production of basic petrochemicals³ are carried out exclusively by Pemex; however, private investment is allowed in: (i) gas transportation, (ii) gas storage (including LNG liquefaction and regasification plants, as well as salt caverns and marginal fields), (iii) gas local distribution (LDC), (iv) gas marketing, (v) gas carburetion stations, and (vi) providing services to Pemex (including oilfield services). Foreign investment in such permitted activities is allowed up to 100%. Natural gas transportation, storage, and distribution include coal-bed methane, and are regulated through permits issued by the Mexican Energy Regulatory Commission (CRE). Pemex and private companies compete in the provision of transportation and marketing services, but Pemex does not participate in the local distribution business. Marketing by private parties is not a regulated activity while first-hand sales by Pemex are indeed a regulated activity.

On the other hand, production and first-hand sales of liquefied petroleum gas (LPG) are carried out exclusively by Pemex. Private investment is allowed in LPG (i) transportation, (ii) storage, (iii) local distribution, and (iv) carburetion stations. Foreign investment is permitted up to 100%, except in distribution (retail) and public transportation, where private investment may participate through “neutral investment” granting the foreign investor economic rights but limited corporate rights.

³ Ethane, propane, butane, pentane, hexane, heptane, carbon black raw material, naphtha, and methane.

Electricity current Legal Framework

Under the Mexican Constitution the generation, wheeling, distribution, and sale of power to the public-at-large are considered a “public service” to be rendered by the Mexican State through *Comisión Federal de Electricidad* (“CFE”) and *Luz y Fuerza del Centro* (“Luz y Fuerza”), both public utilities wholly-owned by the Mexican federal government. In 1992, the energy regulatory framework was amended to allow limited private participation in power generation authorizing: (i) self-supply to fulfill the exclusive and particular needs of individuals and/or entities; (ii) cogeneration to fulfill the exclusive and particular needs of associated establishments requiring both power and steam; (iii) independent power production for sale of power exclusively to CFE; (iv) small scale production for sale of power to CFE to the extent the production capacity of the corresponding power generation project does not exceed 30MW; (v) exportation of power from Mexico to other countries derived from cogeneration, independent power production or small scale production; and (vi) importation of power into Mexico by individuals or entities residing in Mexico exclusively for their own use. However, wheeling, distribution and sale of electricity to the public in general may not be carried out by private parties.

Under Mexican law “public service” means such activities carried out by the Mexican State, directly or through the granting of concessions to private parties, having as purpose the satisfaction of basic public needs on a regular, continuous, and uniform basis. The Electric Energy Public Service Law (*Ley del Servicio Público de Energía Eléctrica*) provides that supply of power as a public service includes the planning of the national electric system and carrying out of all works, installations and construction required for the planning, operation and maintenance of the National Grid (*Sistema Eléctrico Nacional*).

The Energy Reform

The Energy Reform consists of (i) amendments to several federal laws and statutes (but not the Constitution) and (ii) enactment of several federal laws and statutes, as follows:⁴

- Amendments to the Federal Government Executive Branch Statute (*Ley Orgánica de la Administración Pública Federal*)
- Amendments to the Energy Regulatory Commission Statute (*Ley de la Comisión Reguladora de Energía*)
- Amendments to the Petroleum Regulatory Law (*Ley Reglamentaria del Artículo 27 Constitucional en el Ramo del Petróleo*)
- Amendments to the Parastatal Entities Law (*Ley Federal de Entidades Paraestatales*)
- Amendments to the Public Procurement Law (*Ley de Adquisiciones, Arrendamientos y Servicios del Sector Público*)
- Amendments to the Public Works Law (*Ley de Obras Públicas y Servicios Relacionados con las mismas*)
- Enactment of a new Statute of Pemex (*Ley de Petróleos Mexicanos*)
- Enactment of a new National Hydrocarbons Agency Statute (*Ley de la Comisión Nacional de Hidrocarburos*)
- Enactment of a new Law for the Development of Renewable Energy and Energy Transition Financing (*Ley para el Aprovechamiento de Energías Renovables y el Financiamiento de la Transición Energética*)
- Enactment of a new Law for the Sustainable Energy Development (*Ley para el Aprovechamiento Sustentable de Energía*)

Energy Reform - Oil & Gas sector

This section addresses only those legal amendments and new laws enacted relating to the Mexican oil & gas industry as well as contracting with Pemex. The Energy Reform includes basically three levels of changes

⁴ This Memorandum only provides an overview of the legal amendments and new laws enacted; hence it is not a comprehensive analysis of the same.

aimed at creating a strong energy regulatory framework and giving Pemex management and operational flexibility and efficiency:

Creation of, and granting of broader authority to regulatory agencies

Pursuant to the Energy Reform:

- The Ministry of Energy will basically have broader regulatory authority over activities in the energy sector, including the issuance of exploration and production permits (*asignaciones*) to Pemex, and the issuance of technical standards.
- In addition to the regulatory powers that the Energy Regulatory Commission (CRE) already has over natural gas activities, the CRE will regulate (a) first-hand sales (*ventas de primera mano*)⁵ of fuel-oil (*combustóleo*) and basic petrochemicals; (b) fuel-oil and basic petrochemicals pipeline transport, storage, and pipeline distribution; and (c) bio-fuels pipeline transportation, distribution, and storage, including (1) the issuance of permits for conducting such activities, (2) the issuance of directives and price methodologies, and (3) the approval of transportation, storage and distribution services terms and conditions.
- A new National Hydrocarbons Agency (*Comisión Nacional de Hidrocarburos*) will be created as a branch of the Ministry of Energy to deal with the technical regulation and survey of hydrocarbons exploration and drilling.

Corporate, management and business reorganization of Pemex

The Energy Reform basically provide for: (i) reorganization of Pemex's Board of Directors, giving it broader authority and autonomy from the Executive Branch, and including independent members of the Board (experts in the energy sector); (ii) broader management, budgetary, indebtedness, and investment-decision autonomy from the federal government; (iii) creation of subsidiary entities (under the "parastatal" regime) and affiliate companies as well as participating in joint venture companies without requiring authorization from the Executive Branch; (iv) elimination of some procurement constraints and giving Pemex more contracting flexibility, and (v) creation of a special strategy and investment committee and a procurement committee, which will propose the above-mentioned contracting rules and guidelines.

Important to note, Pemex will be able to issue special series of securities to be known as "citizen bonds" (*bonos ciudadanos*), which may only be acquired by Mexican individuals, pension funds, investment funds for individuals and other authorized financial brokers with some limitations, representing Pemex indebtedness and granting the holders of the bonds a return based on Pemex business' performance. The citizen bonds shall not grant any kind of share or participation in Pemex, nor shall grant any corporate, control or property rights on Pemex or Pemex's assets. The rules for issuance, acquisition, and return rate of such bonds will be issued by the Mexican Ministry of Finance (*Secretaría de Hacienda*).

Finally, Pemex will also be able to develop power cogeneration projects within its facilities.

Contracting with Pemex

Pursuant to the Energy Reform private parties will be able to enter into any kind of works and services contracts with Pemex, provided that Pemex shall always maintain control over the exploration and development activities, and provided further that fee payment to contractor or service provider is made in cash (as opposed to payment in kind) and no property, percentage or share over hydrocarbons or Pemex's profits is granted.

⁵ This is the first sale of a hydrocarbon or a by-product made by Pemex to a third party.

Important to note, Pemex will be entitled to explore and exploit on-shore and off-shore cross-border reservoirs (*yacimientos transfronterizos*) in accordance with international treaties entered into by Mexico – although it is not clear in the Energy Reform this may be conducted by it-self or along with international oil companies.

In accordance with the Energy Reform ordinary procurement of goods and services by Pemex will remain subject to current federal government procurement laws and regulations, while substantive contracting by Pemex (*i.e.*, procurement of services and works to conduct the strategic activities, including activities related with E&P and refining) will be subject to *ad-hoc* rules issued by the Pemex's Board of Directors and prepared by a special procurement committee.

As regards procurement of services and works to conduct the strategic activities, including activities related with E&P and refining, awarding of contracts will be done: (i) pursuant to a public bid as a general rule, either limited to domestic bidders or open to international bidders, and (ii) exceptionally through limited tender (3 invitees) and direct awarding. Specifically, Pemex will be able to procure by: (a) direct awarding (as opposed to public bid) in the case services related with environmental contingencies and specific brand equipment spare parts and maintenance services, and (b) limited tender, in the case of development of new technologies related with Pemex strategic activities and engineering, consultant, advisory, survey and educational services.

Likewise, this new contract awarding procedure will allow, among other: (i) pricing negotiation mechanisms; (ii) multi-year works contracts considering contract adjustment due to (a) technological improvements, (b) equipment and raw materials price changes, and (c) additional works resulting from technical information stemming from the services or works performed; (iii) consideration to be paid to contractor either fixed or variable pursuant to a pre-determined formula, and (iv) payment of additional consideration in the event of (a) early performance of the services or works, (b) new or improved technology is transferred to Pemex, or (c) unexpected Pemex's profit, project success or efficiency attributable to contractor, but in no case Pemex will be able to pay contractor a percentage on revenues, production or in kind with oil or gas.

Energy Reform – Electricity sector

This section addresses the new laws enacted relating to power sector, basically promoting and regulating renewable sources, clean technologies, and energy efficiency. The most important features are, as follows:

Renewable Energies

Pursuant to the new Law for the Development of Renewable Energy and Energy Transition Financing (*Ley para el Aprovechamiento de Energías Renovables y el Financiamiento de la Transición Energética*):

- The CRE will (a) issue standards, directives and methodologies regulating power generation from renewable sources; (b) regulate pricing of wheeling, back-up, and other services provided by the Mexican state-owned public utilities (including CFE) to private generating companies using renewable sources; (c) review the public utilities' dispatch rules applicable to private generating companies using renewable sources; (d) issue new interconnection rules; (e) issue energy bank or set-off mechanisms with the public utilities for renewable sources self-supply, cogeneration and small-scale production projects; (f) issue the outline principles to which contracts between the public utilities and private generators (including wheeling, back-up, power excess sales and other) shall abide to.
- The Mexican state-owned public utilities (including CFE) shall enter into long-term contracts with private power generators using renewable sources (*i.e.*, wheeling, back-up, power excess sales and other).
- The Mexican state-owned public utilities (including CFE) shall receive into the National Grid power input from private power generating facilities using renewable sources and render wheeling, back-up, and other services in accordance with the terms and conditions established by the CRE, as well as receive excess power input from such facilities.

- A governmental Renewable Energy Fund (*Fondo para la Transición Energética y el Aprovechamiento Sustentable de Energía*) is created to promote the use of renewable sources and energy efficiency, including providing financing guarantees and support.

Energy Efficiency

Pursuant to the new Law for the Sustainable Energy Development (*Ley para el Aprovechamiento Sustentable de Energía*) a National Commission for Energy Efficiency (*Comisión Nacional para el Uso Eficiente de la Energía*) is created. The purpose of such commission is to promote and regulate (from a technical stand point) energy efficiency. Interestingly for private sponsors to note that such commission shall prepare an energy efficiency program including the modernization of the electric public transport systems in Mexico.

Opportunities for international Oil & Gas and service companies

It is clear that the recent Energy Reform will bring to international and Mexican oil, power, and services companies a large number of business opportunities. Mexico has taken a step forward.