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Energy, Infrastructure and Project Finance

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Landmark Mexican Energy Reform Is Approved

Energy Reform goes far beyond expectations. The 75-year monopoly by state-owned PEMEX ends, and a competitive wholesale power market is created.

On December 12, 2013, the lower house of the Mexican Congress approved the long-awaited energy reform bill (the "Energy Reform"). The Energy Reform was initially discussed and approved by the Senate and then approved by the lower house, in both cases, with the overwhelming majority vote of the members of the ruling Institutional Revolutionary Party (Partido Revolucionario Institucional) and the conservative National Action Party (Partido Accion Nacional).

To come into force, the Energy Reform must be approved by the majority of the 31 local congresses of Mexico, a process that is currently underway, and then published in the *Federal Gazette (Diario Oficial de la Federación)*. To date, 17 local congresses have approved the Energy Reform; accordingly, the bill will now be sent to the President for publication. The Energy Reform will come into force the day after its publication (the "Effective Date").

The Energy Reform consists of the amendment of articles 25, 27 and 28 of the Mexican Constitution and the inclusion of 21 transitional articles, the purpose of which are to set forth the general framework under which the secondary legislation should be drafted and implemented within 120 calendar days following the Effective Date.

I. Oil & Gas

1. Upstream Activities

1.1. No concessions

The Energy Reform does not permit private ownership of hydrocarbons in the subsoil, and expressly prohibits the granting of concessions. Therefore, while hydrocarbons remain in the subsoil, they continue to be the property of the State. However, as discussed below, the Energy Reform does contemplate private ownership of hydrocarbons once extracted from the wellhead and the granting of licenses which operate as "concessions" as the term is commonly used in the industry.

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1.2. Permitted oil contracts for upstream activities

The Energy Reform permits investment by the private sector in upstream oil & gas activities under flexible oil contracts that are standard in the industry. The Energy Reform defines these contractual arrangements as, *"among others"* (the "Upstream Contracts"):

(1) *Pure-service contracts*, where the oil company carries out the E&P activities on behalf of the State, in consideration of a flat fee in cash and all financial risks of development are borne by the State

(2) *Profit-sharing contracts*, where most of the financial risks of development are borne by the oil company, in consideration of a contingent cash payment, based on a percentage of the remaining revenue once the E&P costs are recovered. Oil companies would not own a share of production

(3) *Production-sharing contracts*, where the oil company would provide the financing and bear the risks of the project, in consideration of receiving a share of the production, after cost recovery

(4) *Licenses*, where the oil company acquires title to the hydrocarbons at the wellhead, upon the payment of taxes if commercial production occurs.

As noted above and pending review of the details to be set forth in the secondary legislation, it seems that licenses may operate in a manner very similar to concessions or

(5) Any combination of these arrangements, which will likely result in hybrid contracts.

Please note that the use of *"among others"* anticipates that the secondary legislation could include additional contractual arrangements.

The State is entitled to choose the Upstream Contract that best suits a particular project, in its discretion and on a case-by-case basis, aiming to maximize the State's return and to foster long-term development.

The secondary legislation is expected to expand on the regulation of the Upstream Contracts and determine, among other matters, which contracts will be available for which type of block or field, as well as the applicable taxation system.

1.3. Taxation and government take

The secondary legislation will set forth the taxation system applicable to oil companies—and PEMEX as a *productive state enterprise* [see Section 3 below]—in connection with the extracted production.

The Energy Reform is silent as to whether production would be taxed in the form of: (1) a profit tax, such as a corporate income tax; (2) a royalty or excise tax, that is, a percentage of the value of the production; (3) a bonus; or (4) a combination thereof.

1.4. Booking of oil reserves

The Energy Reform provides that oil companies that enter into Upstream Contracts with the State or PEMEX (in its current form and as a productive state enterprise) may report for *"accounting and financial purposes"* the Upstream Contract and its expected revenue, provided that any such contracts must include an express affirmation that hydrocarbons in the subsoil belong to, and are the property of, the State.

Nevertheless, whether an oil company may book such reserves will depend on compliance with applicable SEC rules, which generally look to the risks the oil company takes in production and its rights upon extraction.

1.5 Round zero licensing

PEMEX is vested with a preferential right to request that it be entitled to carry out E&P activities in specific exploration and production fields (each, an "Allocation"), within 90 days after the Effective Date. To this end, PEMEX must submit an application to the Ministry of Energy (Secretaría de Energía), which decides whether to grant the Allocation or not, with the technical assistance of the National Hydrocarbons Commission (Comisión Nacional de Hidrocarburos, "CNH" for its Spanish initials), within 180 days after the respective filing. PEMEX may also be required to pay compensation for the Allocation.

In order to qualify for an Allocation, PEMEX must demonstrate that it possesses the necessary technical, financial and administrative capabilities to carry out the E&P activities in an efficient and competitive manner.

Fields not chosen by PEMEX will be administered by the State, and will be subject to open bidding processes for the award of Upstream Contracts. It is expected that PEMEX will pass on undeveloped or unconventional fields, such as shale gas reservoirs.

If the Ministry of Energy approves an application by PEMEX, it is entitled to determine the area, depth and term of the Allocation, taking into account that:

(1) If PEMEX has made investments for exploration in a particular exploration field or found *"commercial discoveries"* in such field on or before the Effective Date, it may enjoy a continued exploration right for a period of three years, renewable for up to two additional years, subject to a pre-established exploration plan. If successful, PEMEX shall be entitled to carry on with production activities. Otherwise or if PEMEX fails to comply, the field shall revert to the State and

(2) As to production fields, PEMEX will maintain its rights in any production field that is operating on or before the Effective Date.

Allocations may not be transferred without the approval of the Ministry of Energy.

PEMEX may request that the Ministry of Energy authorize the conversion of an Allocation into Upstream Contracts. In such cases, (1) the CNH shall carry out the respective bidding process; (2) the Ministry of Energy shall establish the technical and contractual guidelines of such bid; and (3) the Ministry of Finance shall establish the applicable tax regime. Such converted Upstream Contracts shall be subject to the same rules as regular Upstream Contracts.

1.6. Competitive public procurement—transparency principles

The Energy Reform mandates the enactment of public procurement rules for the awarding of Upstream Contracts and Allocations, which shall apply to both oil companies and PEMEX and are intended to guarantee transparency as follows: (1) requests for proposals may be reviewed by any interested third party, rather than just bidders; (2) Upstream Contracts must include clauses permitting public disclosure in order for any third party to review them; (3) external audits must be conducted to supervise the recovery of costs incurred and other accounting aspects of the operation of such Upstream Contracts; and (4) disclosure of consideration, taxes and other payments provided in the Upstream Contracts is obligatory.

1.7. Eminent domain

The exploration and extraction of hydrocarbons are deemed of "social interest and public order", hence taking priority over any other activity that affects the surface or subsoil of any given real estate. The secondary legislation will set forth the rules for compensating the use of such real estate, which hints at the possibility of a special regime for expropriating property in the interest of E&P activities.

2. Liberalization of Midstream and Downstream Sectors

The Energy Reform opens the midstream and downstream sectors (natural gas processing, oil refining and transport, storage, distribution and selling of hydrocarbons and petrochemicals and their derivatives) to private investment, as they are no longer reserved exclusively for the State.

3. PEMEX as a Productive State Enterprise and Competitor

PEMEX is required to transform into a *productive state enterprise* (empresa productiva del Estado), within two years after the publication of the Energy Reform, pursuant to the terms and conditions to be set forth in the secondary legislation.

The immediate consequence of such transformation is PEMEX becoming another competitor in the marketplace alongside oil companies.

Upon PEMEX's transformation into a productive state enterprise: (1) its corporate purpose shall be to increase the economic value and revenue of the State; (2) it shall enjoy budgetary autonomy; (3) its organization, administration and corporate governance shall be arranged in keeping with best international practices; (4) its CEO shall be appointed by the President and removed by the President or the board of directors; and (5) a particular regime shall be established regarding public procurement, budgeting and public debt, among others, in order to allow it to efficiently compete in the market place.

Under the new legislation, the board of directors of PEMEX shall be composed of ten members: five government members, including the Ministry of Energy as board president—which shall enjoy a tie-breaking vote-, and five professional independent advisers. Therefore, PEMEX's union is stripped of its five seats on PEMEX's current board of directors.

During the two-year transitional phase and thereafter, PEMEX shall be entitled to be awarded with Allocations and Upstream Contracts.

PEMEX may also request that the Ministry of Energy convert PEMEX's existing contracts into Upstream Contracts, so that PEMEX may, in turn, contract with oil companies.

The transitional articles also imply that it may be possible to incorporate more productive state enterprises dedicated to E&P activities in addition to PEMEX.

4. Mexican Petroleum Fund for Stabilization and Development

The Energy Reform provides for the establishment in 2014 of a sovereign wealth fund called the Mexican Petroleum Fund for Stabilization and Development (Fondo Mexicano del Petroleo para

la Estabilizacion y el Desarrollo, the "Fund"). The Fund will be established in the form of a public trust, whose trustee will be Mexico's Central Bank (Banco de México). The Fund is expected to begin operations in 2015.

The Fund will be entrusted with the receipt, administration and distribution/investing of oil revenues obtained by the State (net of taxes) under the Upstream Contracts and the Allocations.

The estate of the Fund will be managed and allocated pursuant to a specific payment waterfall that includes, among other concepts: (1) at the top of the waterfall, the payment of the consideration agreed under the Allocations and Upstream Contracts; (2) payments to cover shortfalls in the federal budget, but limited to 4.7 percent of gross domestic product; and (3) long-term savings and investments in financial assets.

The Fund shall have a steering committee composed of the Ministry of Finance, the Ministry of Energy, Mexico's Central Bank governor and four independent members appointed by the President, with the approval of two-thirds of the members of the Senate.

5. Regulators and new agency

Within 120 days after the Effective Date, the secondary legislation shall vest federal regulators with the following authorities:

- The Ministry of Energy shall be responsible for, among others: (1) the establishment and coordination of Mexico's energy policy; (2) the award of Allocations; (3) the determination of the fields to be subject to Upstream Contracts; (4) the technical design of the Upstream Contracts; (5) establishing technical guidelines for public procurement; and (6) granting permits for the downstream sector (refining of petroleum crude oil and processing of raw natural gas).
- The CNH shall be responsible for, among others: (1) serving as the technical advisor to the Ministry of Energy; (2) conducting the bidding process and awarding and supervising Upstream Contracts; and (3) enacting E&P regulation in general. The CNH will be restructured as an autonomous governmental agency, with technical and operational autonomy, entitled to charge fees for services rendered to cover its budget, although such budget will be complemented with proceeds from the federal budget.
- The Energy Regulatory Commission (Comisión Reguladora de Energía, the "CRE") shall be responsible for, among others: (1) granting permits related to midstream activities (e.g., storage, transportation and distribution of oil, gas, refined products and petrochemicals by pipelines); (2) regulating the access of third parties to transportation pipelines and storage facilities of hydrocarbons and their by-products; and (3) regulating first hand sales of these products. The CRE shall be restructured as an autonomous governmental agency, with technical and operational autonomy, entitled to charge fees for services rendered to cover its budget, although such budget will be complemented with proceeds from the Federal Budget.
- The Ministry of Finance (Secretaría de Hacienda) shall be responsible for, among others, establishing (1) the fiscal/tax regime for Upstream Contracts and (2) financial terms for the requests for proposals.
- Within 12 months after the Effective Date, the executive branch will create the National Center of Natural Gas Control (Centro Nacional de Control del Gas Natural), as a decentralized government entity, which shall be responsible for the operation of the national pipeline system for the transportation and storage of natural gas. All contracts currently under PGPB will be transferred to this new governmental entity.

II. Power Sector Reform

1. Competitive Wholesale Power Market

1.1. Power generation is no longer deemed a public service

The Energy Reform eliminates the prohibition on power generation and retailing for public service purposes by private utilities, thus creating a competitive spot market in power generation. Previously, private utilities could only participate in limited power generation activities. Congress must enact secondary legislation within 120 days after the Effective Date.

2. Public Service and Activities Reserved for the State

2.1. Transmission and distribution

Power transmission and distribution remain public services exclusively reserved to the State and private concessions are expressly forbidden. Section 1.7 above applies to these activities as well. The secondary legislation will establish the contractual arrangements under which private companies may participate, on behalf of the State, in the financing, installation, operation, maintenance and expansion of the necessary infrastructure for the rendering of transmission and distribution of electricity for public service.

No concessions may be granted by the State in this respect.

2.2. Planning and control of the National Electric Grid

- Planning and operational control of the national electric grid (Sistema Eléctrico Nacional) remain exclusively reserved to the State.

3. Federal Electricity Commission as a *Productive State Enterprise and Competitor*

The Federal Electricity Commission ("CFE") is required to transform into a *productive state enterprise (empresa productiva del Estado)* within two years after the publication of the Energy Reform, pursuant to the terms and conditions to be set forth in the secondary legislation.

Upon CFE's transformation into a productive state enterprise: (1) its corporate purpose shall be to increase the economic value and revenue of the State; (2) it shall enjoy budgetary autonomy; (3) its organization, administration and corporate governance shall be arranged in keeping with best international practices; (4) its CEO shall be appointed by the President and removed by the President or the board of directors; and (5) a particular regime shall be established regarding public procurement, budgeting and public debt, among others, in order to allow it to efficiently compete in the market place.

4. Regulators and New Agency

Within 120 days after the Effective Date, the secondary legislation shall vest federal regulators with the following authorities:

- The Ministry of Energy shall be responsible for, among others, establishing the terms and conditions that would allow and foster open access and efficient operation of the power sector.
- The CRE shall be responsible for regulating and granting permits for power generation, as well as regulating dispatch fees for transmission and distribution.
- The Energy Reform provides the establishment of the National Energy Control Center (Centro Nacional de Control de Energía, the "CNCE") within 12 months after the Effective Date. The CNCE will be a decentralized governmental entity responsible for: (1) operational control of the national electric grid and the wholesale power market; and (2) ensuring free access to the national electric grid and national electricity distribution network.