WHITE & CASE

Client**Alert**

Energy, Infrastructure, Project and Asset Finance

August 2013

Mexican Energy Sector Overhaul

Long-Awaited Energy Reform on the Table
President Peña Nieto Unveils Reform Proposal

On August 12, 2013, President Peña Nieto submitted to Congress a bill amending articles 27 and 28 of the Federal Constitution, aiming to reform the oil & gas and power sectors in Mexico (the "Bill"). The Bill is being submitted in the context of the "Pact for Mexico," which is a pact among the three main political parties to create the consensus required to enable Congress to pass necessary structural reforms.

1. Oil, Gas and Petrochemicals

Restriction on Entering Into Profit Sharing Arrangements With Private Companies to Be Repealed

The Bill proposes to eliminate from the Federal Constitution a provision that prohibits the Mexican Government from entering into exploration and production contracts with private companies. The specifics of this new regime will not be fully known until secondary laws are implemented.

Although the explanatory memorandum published with the Bill is far from clear or exhaustive, the Bill confirms the ownership of oil and gas reserves by the State and further prevents private companies from investing in reserves through concessions. Thus, product sharing contracts, in which the private company is vested with ownership of oil itself, are not permitted. Public statements by key federal officials confirm our interpretation.

The explanatory memorandum anticipates "profit-sharing contracts" (contratos de utilidad compartida) with payment "by means of consideration payable in cash or in accordance with the resources found". In our view, the Bill provides for the possibility of service contracts for a fixed fee or, more likely, for a variable and escalating fee based on the oil produced (risk service).

The reference to "profit-sharing" evokes the notion that any consideration would be contingent on whether the venture yields a profit. We believe, however, that the reimbursement of operating and capital costs incurred by private companies in exploration activities would be guaranteed by the State, as explained in the accompanying materials to the Bill prepared by the president's office.

Mexico
José Vicente Corta Fernández
Partner
+ 52 55 5540 9602
vcorta@whitecase.com

Sean Goldstein
Partner
+ 52 55 5540 9622
sgoldstein@whitecase.com

José Ignacio Segura Alonso
Partner
+ 52 55 5540 9694
isegura@whitecase.com

Hernán González
Associate
+ 52 55 5540 9659
hgonzalez@whitecase.com

New York
Someera Khokhar
Partner
+ 1 212 819 8846
skhokhar@whitecase.com

Miami
Christian Hansen
Partner
+ 1 305 995 5272
chansen@whitecase.com

Carlos Viana
Partner
+ 1 305 995 5251
cviana@whitecase.com

Liberalization of Midstream and Downstream Sectors

Midstream and downstream sectors, that is, natural gas processing, oil refining and transport, storage, distribution and selling of hydrocarbons and petrochemicals and their derivatives, are no longer reserved exclusively for the State. These activities may now be undertaken by private companies under permits granted by the State.

PEMEX Restructuring

PEMEX would be consolidated to eliminate overlapping activities by its four current subsidiaries, namely: Pemex-Exploración y Producción, Pemex-Refinación, Pemex-Gas y Petroquímica Básica and Pemex-Petroquímica. The explanatory memorandum calls for only two divisions within PEMEX, (a) Exploration and Production, covering the upstream sector, which to date is the only profitable business of PEMEX, and (b) Industrial Transformation, covering the transformation processes of oil and gas.

PEMEX Tax Regime

The explanatory memorandum anticipates an upcoming tax reform that would provide a reduction in the taxes paid by PEMEX, as well as the ability of PEMEX to keep its after-tax profits for reinvestment, provided that a portion may still be transferred as a dividend payment to the federal budget.

Radioactive Materials

The Bill ratifies the prohibition on granting private sector concessions or contracts in respect of radioactive materials. This shall remain reserved exclusively for the State.

2. Power Sector

Restriction on Private Sector Participation in Power Generation and Retailing to Be Repealed

The Bill proposes the elimination of the prohibition on power generation and retailing for public service purposes by private utilities, thus creating a competitive spot market in power generation. Although the generation sector was partially opened to private participation in the 1990s, the State-owned utility, Federal Electricity Commission (Comisión Federal de Electricidad, "CFE"), has remained the dominant player, as private participation has been limited to a handful of activities, the most important of which have been the independent power production program (for exclusive sale to CFE) and generation for self-supply.

CFE will now be required to compete with private power companies in the power generation market.

State Remains the Owner and Operator of the National Transmission Grid

In order to safeguard the grid extension and guarantee universal access to end-users, the State shall remain the owner and controller of the national transmission grid (Sistema Eléctrico Nacional), through a dispatch mechanism, which would be applicable to both CFE and private generation companies.

The explanatory memorandum provides that a public entity (independent of CFE) shall ensure equal and fair access to interested private power generators. Furthermore, such operator must guarantee that end-users receive energy from private generators that offer the best prices. For the time being, the identity of such independent public operator is unknown.

The State shall have the authority to enforce quality, continuity and efficiency standards in the supply of electricity to end-users.

Power Transmission and Distribution Shall Remain Exclusively Reserved for the State

Power transmission and distribution shall remain a public service exclusively reserved for the State. While the State is restricted from granting private sector concessions, the Bill opens the door for private companies to render auxiliary services to the State (not end-users) that enable the rendering of such services. Energy generated by private companies would still have to be transmitted and distributed through CFE.

3. Implementing Secondary Legislation

The explanatory memorandum notes that secondary legislation is required to implement the constitutional reforms. This legislation will be of the essence to assess the true impact and repercussions of the Bill.

4. Conflicting Bills

The National Action Party (PAN) presented its own bill on July 31, 2013. The Party of the Democratic Revolution (PRD) has announced its upcoming bill will be presented by August 19, 2013.

The PAN's bill provides a more aggressive proposal that allows oil concessions, while the PRD has announced its opposition to constitutional amendments. Upon their submission, it is expected that these bills, along with the Bill, will be discussed when the Congress reconvenes on September 1, 2013.

5. Constitutional Requirements for the Passage of the Bill

A constitutional reform requires the approval of two thirds of the Congress followed by the approval of the majority of the 32 local congresses of Mexico (one congress for each of the 32 Mexican states).

The Bill requires at least 86 votes in the Senate to be approved. The ruling Institutional Revolutionary Party (PRI), which is the president's political party, has 54 seats; therefore, at least 32 votes from other parties are needed. The PAN has enough seats to give the additional 32 votes required.

In the House of Representatives, the PRI requires 333 votes out of the 500 seats to approve constitutional reforms. The PRI has 213 seats and the PAN may theoretically contribute up to 114 votes. Six additional votes would still need to be secured.

- It is not clear if the Bill will be approved; however, it is commendable that the long-awaited debate amongst the main actors in the energy industry has commenced.
- Although private companies will not own oil and gas reserves, the reform marks the largest private sector liberalization in decades for Mexico's energy industry.
- The proposed reform will likely focus on creating new contract schemes for deep water oil and gas reserves (and eventually shale gas) through joint ventures with private companies. This would permit PEMEX to tap into the huge balance sheets, technological know-how and project management experience of the international oil companies.
- We expect the first profit-sharing contracts to be bid-out in mid-2014.
- While in our experience profit-sharing contracts are typically unpopular with international oil companies, we expect that the liberalization proposed by the Bill will still prove to be an attractive regime given Mexico's reserve potential, particularly for deep-water and shale gas.

Mexico City
White & Case, S.C.
Torre del Bosque - PH
Blvd. Manuel Avila Camacho #24
Col. Lomas de Chapultepec
11000 México, D.F.
México
+ 52 55 5540 9600

New York
White & Case LLP
1155 Avenue of the Americas
New York, New York
10036-2787
United States
+ 1 212 819 8200

Miami
White & Case LLP
Southeast Financial Center
200 South Biscayne Boulevard
Suite 4900
Miami, Florida
33131-2352
United States
+ 1 305 371 2700

NY0813/EIPAF/A/08337_04