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What you need to know about Mexico's energy reform

Introduction

Mexico is undertaking a complete transformation of its energy sector. In December 2013, Mexico's Congress approved a series of constitutional amendments that will end the 75-year state oil monopoly and open oil and gas exploration and production to foreign investment. Just last August, Mexico's Congress approved secondary legislation implementing the necessary reforms for the liberalization of the energy sector (the **Secondary Legislation**).

The impetus for Mexico's energy reform is clear: the government seeks private investment to boost oil and gas exploration and production, which have been in decline for the past 10 years. In particular, the government hopes that private investors will assist the state-owned petroleum company PEMEX to exploit future fields, including Mexico's promising shale oil and gas fields and its deep-water oil resources.

This reform is likely to have a profound impact on long-term oil and gas production in Mexico. The U.S. Energy Information Administration (the **EIA**) estimates that the reform could yield a potential increase of 75 percent in Mexico's long-term oil production, thus opening unprecedented opportunities for investors in the sector.

In this briefing, we provide an update on Mexico's energy sector reform, including an overview of the key components of the Secondary Legislation.

Overview of the new legal framework for the oil and gas industry

The new PEMEX

Pursuant to the Secondary Legislation, PEMEX will become a "state-owned productive company" (*empresa productiva del Estado*) and more independent from the Mexican government. The Mexican government will, nevertheless, retain a degree of control over PEMEX's operations. For example, the government will appoint a number of PEMEX's top officials and will be involved in decisions regarding the distribution of dividends. The government will also select – through a bidding process – the private companies with which PEMEX may collaborate.

New sector regulators

The Secondary Legislation divides the responsibility for regulatory oversight among five agencies:

(a) the Energy Secretariat (*Secretaría de Energía* or **SENER**) will be involved in selecting new areas to open to public bidding and issuing permits for refining, processing, importing and exporting hydrocarbons;

(b) the Finance Secretariat (*Secretaría de Hacienda*) will determine the fiscal terms for the contracts;

(c) the National Commission of Hydrocarbons (*Comisión Nacional de Hidrocarburos*) will administer the bidding rounds for the contracts and will handle all exploration and production contracts;

(d) the Energy Regulatory Commission (*Comisión Reguladora de Energía*) will issue permits for distributing, marketing and selling oil and gas (among other activities), and may pass regulations to promote competition in the energy sector; and

(e) the National Agency of Industrial Safety and Environmental Protection (*Agencia Nacional de Seguridad Industrial y de Protección al Medio Ambiente del Sector Hidrocarburos*) will regulate and supervise the industrial safety and environmental aspects of the hydrocarbon sector.

Upstream activities

In order to end PEMEX's monopoly, the reform reallocated Mexico's hydrocarbon resources. This reallocation was recently effected through the "Round Zero" process. Foreign investors will participate in the sector through different types of contracts, which will be awarded in subsequent bidding rounds.

Round Zero: PEMEX's initial bid

To reallocate its productive assets, the Mexican government launched the "Round Zero" process, which allowed PEMEX to make initial bids over areas for exploration and development. To do so, PEMEX was required to demonstrate that it had the technical and financial capability to develop the fields and areas it bid on. During Round Zero, PEMEX asked to retain 380 producing fields and 165 exploration areas.

The process concluded on August 13, 2014 and PEMEX was allowed to retain 83 percent of the country's proven and probable reserves (the entirety of what PEMEX had requested) and 21 percent of its prospective resources (67 percent of what PEMEX had requested). PEMEX will be granted "entitlements" over these areas – special titles to carry out exploration and production activities. Going forward, PEMEX will have to compete alongside private companies for access to new fields and areas.

Importantly, PEMEX's entitlements can be migrated into one of several types of contracts envisaged in the reform (described below), thus allowing PEMEX to partner with private companies. PEMEX has already indicated that it intends to migrate some 10 projects into some form of contract in association with private companies to be selected by the government in a bidding process. It is likely that the government will include such projects, as well as the areas not assigned to PEMEX, in bidding rounds scheduled for early 2015.

Round One: Participation by private parties

Private companies can participate in the upstream sector by entering into contracts with the government. Under the reform, the following types of contracts are available to private companies:

- **License contracts**. While reserves in the ground remain state property, contractors receive the hydrocarbons in-kind at the wellhead in exchange for certain cash payments (including an upfront signing bonus, exploratory phase fees, royalties, and a percentage of the operating profits).

- **Profit-sharing/Production-sharing contracts**. Contractors recover their costs and keep a percentage of production or profits. In exchange, contractors must pay certain exploratory-phase fees and royalties.

- **Service contracts**. Contractors deliver all production to the government in exchange for a cash payment established in the contract.

These contracts will be granted only to Mexican companies. Therefore foreign investors must incorporate Mexican entities to channel their investments. Also, contractors will be required to procure a percentage of their goods and services from Mexican providers (the minimum percentage will increase gradually from 25 percent in 2015 to 35 percent in 2025). Further, each contract will include certain adjustment mechanisms to ensure that the Mexican government will receive a portion of any “extraordinary” profits.

Finally, in order to promote transparency, the pre-bidding rules must be public and open to comments from the private sector.

Downstream activities

Regulation of the midstream and downstream sectors of the industry will likewise be reformed:

- **Private companies will be allowed to operate by permit**. Permits will be available from the Energy Secretariat or the Energy Regulatory Commission.
- **Oil transportation and storage infrastructure will be available to all users in the country**. These services are currently controlled by Mexican state-owned companies.
- **The retail market will be liberalized over time.** As of 2016, any interested party can obtain a permit to set up service stations to sell fuels from any company (not just PEMEX); as of 2017, private companies can freely import oil products into Mexico; as of 2018, all price controls on fuels will be eliminated.

Gas sector

According to the EIA, Mexico has the sixth-largest reserve of technically recoverable shale gas in the world. Currently, the gas transport infrastructure is controlled mostly by PEMEX and the Comisión Federal de Electricidad (**CFE**) and a few private companies. To incentivize domestic production, Mexico will improve the transport system for natural gas.

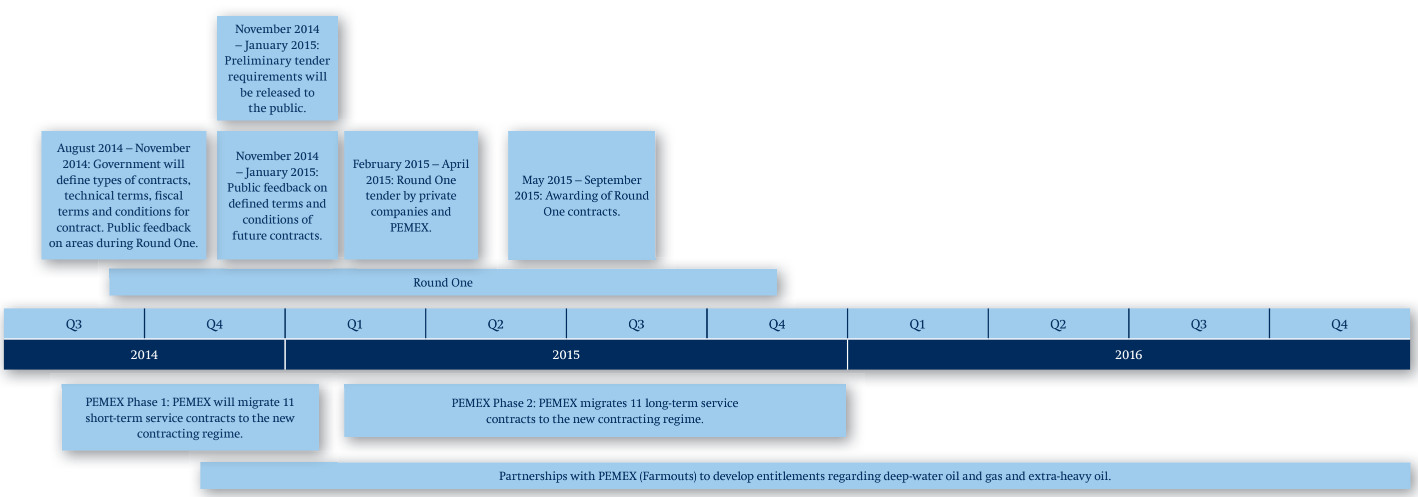
To improve competition, management of the integrated system of gas transportation and storage will be handed over to the newly created National Natural Gas Control Center (**CENAGAS**). Both PEMEX and the CFE will transfer their existing gas transport and storage assets and contracts to CENAGAS. CENAGAS will tender gas infrastructure projects to private and state-owned companies.

Within this new framework, in July 2014 PEMEX awarded a contract to build a section of the Los Ramones pipeline that will link the US natural gas transportation network with Mexico. The pipeline will be constructed by a consortium consisting of the Brazilian engineering and construction company Odebrecht, the Argentine/Italian group Techint and the Mexican construction company Arendal.

Next steps

The estimated time frame for Mexico’s implementation of its energy reform is as follows:

Mexico’s energy reform – estimated time frame



Impact on Mexico’s long-term oil output

Following the enactment of Secondary Legislation, the EIA released its International Energy Outlook 2014 (IEO2014) this month. In its prior outlook (IEO2013), it had projected that “Mexico’s production would continue to decline from 3m barrels per day (MMbbl/d) in 2010 to 1.8 MMbbl/d in 2025 and then struggle to remain in the range of 2.01 to 2.1 MMbbl/d through 2040.” In contrast, the EIA now “takes a cautiously optimistic view of the potential for successful reform,” projecting that Mexico’s production will stabilize at 2.9 MMbbl/d through 2020 and then rise to 3.7 MMbbl/d by 2040. Importantly, it therefore estimates that the reform could result in an increase in Mexico’s long-term oil production of up to 75 percent. In the words of the EIA, “with 10bn barrels of proved oil reserves and potentially large volumes of hydrocarbon resources in Mexican territory in the deep-water Gulf of Mexico, the potential is enormous, and successful implementation of the energy reforms could substantially transform the outlook for Mexico’s oil production.”

For more information please contact:

Melissa Raciti-Knapp
Partner
T +1 212 277 4035
E melissa.raciti@freshfields.com

Noiana Marigo
Partner
T +1 212 284 4969
E noiana.marigo@freshfields.com

Graham Watson
Partner
T +44 20 7832 7263
E graham.watson@freshfields.com

Alex Wilbraham
Counsel
T +1 202 777 4508
E alex.wilbraham@freshfields.com

Jeffery Commission
Senior Associate
T +1 202 777 4506
E jeffery.commission@freshfields.com

Juan Pomes
Associate
T +1 202 777 4535
E juan.pomes@freshfields.com

Guadalupe Lopez
Associate
T +1 202 777 4504
E lupe.lopez@freshfields.com

freshfields.com