December 16, 2013

Mexico Energy Reform

Introduction

On December 12, 2013, the Mexican House of Deputies passed a constitutional reform bill approved by the Senate the day before that is intended to open the Mexican energy industry to increased participation from international energy players and spur the development and expansion of the Mexican energy industry (the "***Energy Reform Bill***"). The Energy Reform Bill seeks to amend three articles of the Mexican Constitution (the "***Constitution***") and it provides 21 transitional articles detailing the regulatory and legal framework to be established to implement these reforms (the "***Transitorios***"). After a vigorous debate from the opposition, the Senate, followed by the House of Deputies, overwhelmingly approved the amended bill sponsored by the PRI, the ruling Mexican political party. In order to be published and become law, the Energy Reform Bill must be approved by a majority of Mexico's State Legislatures. The political pact between the PRI and the PAN, the Mexican minority political party, should easily be able to pass this hurdle now that the Senate and House of Deputies have approved the Energy Reform Bill.

Overview of the Reform

The Energy Reform Bill would amend Articles 25, 27 and 28 which currently provide a monopoly for certain state owned entities and limit private investment in the energy sector. The Transitorios set forth the standards by which the secondary laws of the energy sector, the "*Ley Reglamentaria*," will be modified. This implementing legislation will be a key factor in further defining the impact and breadth of reforms, and how much the energy sector in Mexico will really open to outside investment. Once implemented, the Energy Reform Bill will put an end to the state energy sector monopolies that have been in place since the government took over operations in 1938 and encourage private investment in the upstream, midstream and downstream oil and gas sectors. In addition, for the first time in decades, refining, transportation, storage and distribution of oil and refined products would be open to the private sector.

In the upstream sector, the Energy Reform Bill would allow foreign companies to explore and drill for oil and gas in return for royalties, but would include a series of taxes payable to the Mexican government. Of particular importance to oil and gas companies listed publicly in the United States, the Energy Reform Bill seems to be intended to have the implementing legislation be in accordance with the SEC's Rule 4-10 which allows entities to list reserves on their financial statements when there is a reasonable expectation that there is "the legal right to produce or a revenue interest in the production."

The Energy Reform Bill will allow the Mexican Ministry of Energy to grant oil and gas development rights to private companies in the form of service contracts, utility contracts, production sharing/joint venture contracts, and licenses. The Energy Reform Bill stops short of allowing concessions to private companies, and it clearly retains the fundamental principal of the Mexican ownership of all resources that remain in the ground, a point that must be affirmed in all future assignments or interests and contracts.

In addition to overhauls of the oil and gas industry, the Energy Reform Bill drastically changes the country's power generation policies. The Energy Reform Bill seeks to create a wholesale market operator independent of the Mexican government with the goal of incentivizing private investment in power generation. Electricity distribution and transmission is set to remain under control of the Mexican government.

Next Steps for the Bill to Become Law

Pursuant to Article 135 of the Constitution governing amendments, the reform must now be accepted by the majority of Mexico's 32 State Legislatures to become law. Approval of the Energy Reform Bill is anticipated as there are PRI affiliated governors in almost two thirds of the states. As of December 15, 2013, 11 of the states have approved the Energy Reform Bill (Chiapas, Campeche, Baja California Sur, Coahuila, Sonora, Veracruz, Queretaro, Mexico State, Hidalgo, Durango and Jalisco). After approval by at least six more states, the Mexican Congress shall declare the authorization and publication of the amendments and reforms. The Energy Reform Bill with go into effect the day after publication.

Key Provisions of the Energy Reform Bill

The Energy Reform Bill provides that once it is finally published, within 120 days of the law taking effect, the Mexican Congress is required to issue all of the secondary laws, as provided for in the Transitorios, the key features of which are as follows:

- A contractual regime for the participation of private investment in the upstream sector will be established for service contracts, utility contracts, production sharing/joint venture contracts, and licenses. In each case, the Ministry of Energy will determine the best model to be used in order to maximize profitability for Mexico.

- Private investors that enter into an agreement with either the Mexican government or the state-run oil company ("***Pemex***") will be allowed to report, for accounting and financial purposes, the awarding of the contracts and related hydrocarbon reserves and will be able to record the benefits of the projects as forecasted.

- The authorization of industrial oil-related activities, such as crude oil refining and gas processing by the Ministry of Energy.

- A "Round Zero" will take place in which Pemex will be able to select the exploration and production areas it will continue to manage.

- The establishment of a legal system for the participation of private investment in the generation and commercialization of electricity by any source except nuclear energy.

- The creation of an independent wholesale electricity system operator (CENACE) to provide non-discriminatory access to power-generating companies within the transmission industrial process.

- The creation of the Mexican Petroleum Fund for Stabilization and Development as a government trust to collect and administer all of the income derived from the contracts with oil and gas companies and direct awards to Pemex.

- The creation of the *Agencia Nacional de Seguridad Industrial y de Proteccion al Medio Ambiente del sector de Hidrocarburos* (National Agency of Industrial Security and Environmental Protection of the Hydrocarbon Section), an independent and decentralized agency responsible for regulating and supervising operational security and environmental protection.

Constitutional Modifications

The Energy Reform Bill revises the fourth, sixth and eighth paragraphs of Article 25, the sixth paragraph of Article 27, the fourth and sixth paragraphs of Article 28 and adds a seventh paragraph to Article 27 and an eighth paragraph to Article 28 of the Constitution.

Amended Article 25 reflects the changes to the electric, oil and gas sectors as revised in Article 27 discussed below, requiring the establishment of administrative regulations and legal amendments in the industry to assure efficiency, effectiveness, honesty, productivity, transparency and accountability based on industry best practices. The amendment adds sustainability as a guideline to be used by the public sector to promote the private and social sector of the economy.

Prior to the Energy Reform Bill, Article 27 vested ownership of all oil and gas in the State. As amended, the energy sector is to be opened to allow for private investment but stops short of allowing concessions to private companies. The electricity generation market is also opened to the private sector while maintaining exclusive control of the national electricity system as well as the transmission and distribution of electricity.

Although Article 28 of the Mexican Constitution prohibits monopolies, originally all elements of the oil and gas and electricity industries were excluded from such characterization. Once the Energy Reform Bill is effective, the monopoly in the electric power industry will be reduced to the planning and distribution of the national electric system, and the oil and gas monopoly will be restricted to align with the terms set out in the modified Article 27. The Energy Reform Bill also creates the *Fondo Mexicano del Petróleo para la Estabilización y el Desarrollo* (Mexican Petroleum Fund for Stabilization and Development) and vests executive power in the Comisión Nacional de Hidrocarburos (CNH) and the Comisión Reguladora de Energía (CRE).

Comparison to the Proposed Bill of December 8, 2013

Interestingly, the original bill submitted by the PRI did not push reforms as far as the eventual Energy Reform Bill that was passed last week. This is a positive sign for the oil and gas industry, as there were some suggestions among international oil companies that the bill did not go far enough. The Energy

Reform Bill, as passed by Congress, demonstrates further flexibility and sensitivity on the part of the Mexican government to the key driving factors that incentivize foreign direct investment in the energy sector.

General Outlook for Energy Reform

Passage of the Energy Reform Bill is a tremendous step in the long process towards an open energy market in Mexico. Mexico has made progressive efforts to invite more investment into its energy sector throughout the years, taking the first step in 2001 with the introduction of multiple service contracts. Progress continued in 2008 with reforms aimed at giving Pemex greater budgetary authority, updating its corporate structure and allowing the company to contract with foreign firms to improve production and exploration endeavors. The Energy Reform Bill is an indication that Mexico is on its way to completing the long and climb towards further opening its energy sector.

Looking to the Future

It is clear that the Energy Reform Bill will have significant consequences for the Mexican energy sector. The Energy Reform Bill has tasked legislators with developing the institutions and the legal framework for enacting these reforms. As secondary legislation is passed to effectuate the Energy Reform Bill, close attention should be paid to changes proposed to the "*Ley Reglamentaria*" and to the oil and gas regulator the Comisión Nacional de Hidrocarburos (CNH). Developments in this secondary legislation will define the true path of the Mexican energy sector.

Contact Information

If you have any questions regarding this alert, please contact:

Steven P. Otillar
sotillar@akingump.com
713.250.2225
Houston

Dino Elizardo Barajas
dbarajas@akingump.com
310.552.6613
Los Angeles

