

Akin Gump Client Update

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Mexico Energy Reform – Secondary Legislation Submitted to Congress

Introduction

On April 30, 2014, President Enrique Peña Nieto formally presented to the General Congress of the United Mexican States (Congress) the much anticipated secondary legislation to implement the revolutionary constitutional changes that were passed in December 2013. His sweeping proposal includes nine new bills, as well as amendments to several existing laws. While many industry players predicted that the legislation would not be introduced before the end of the legislative session in April, President Peña Nieto again exceeded expectations.

Overview of the Proposed Secondary Laws

The nine proposed bills are as follows:

- Draft decree on the Hydrocarbons Law, with amendments to the Foreign Investment Law, Mining Law and Public Private Partnerships
- Draft decree on the Electricity Industry Act
- Draft decree on the Geothermal Energy Act, with amendments to the National Water Law
- Draft decree on the National Agency for Industrial Safety and Environmental Protection in the Hydrocarbons Sector
- Draft decree on the PEMEX Law and CFE Law, and amendments to the Public Entities Law, Acquisitions Law, Public Sector Leases and Services Law and Public Works Act
- Draft decree on Coordinated Regulatory Bodies in energy and amendments to Federal Public Administration Laws
- Draft decree on the Mexican Petroleum Fund for Stabilization and Development
- Draft decree on the Law on Hydrocarbons Revenue
- Draft decree amending various provisions of the Federal Budget and Tax Laws

Next Steps for the Proposed Secondary Legislation

Pursuant to Articles 71 and 72 of the Constitution, the proposed legislation will now be reviewed by both the Deputy and Senator Chambers of Congress. It must be approved by a majority vote in both

Chambers. The proposed legislation was presented at the end of the congressional session on April 30 with the next congressional session set to begin in September. However, Congress announced an extraordinary session to be held in the second half of June to address the proposed legislation. Because this legislation only requires a majority vote, as opposed to the underlying constitutional reforms that required an agreement among the PRI and PAN political parties to satisfy the supermajority vote of at least two-thirds of the Congress, PRI leaders believe that the reforms will be passed in the extraordinary session and it will not be necessary to carry the debate over to the regular sessions in September. Once majority approval is acquired, the proposed legislation will be returned to the Executive Branch for final approval and publication.

Upstream Sector

Some highlights of the legislation for the upstream sector include:

- Exploration and extraction contracts can be entered into with PEMEX or others through an auction process. Such agreements can be terminated for material breach, but disputes will be resolved by arbitration under Mexican law.
- It will become possible to obtain a contract for gas development in an operating coal mine.
- PEMEX is allowed to be given direct assignment of oil and gas blocks for “strategic projects.” PEMEX must receive at least a 20% participating interest in trans-boundary oil and gas projects. Unlike the Brazilian pre-salt model, PEMEX will not have to be the operator and will merely participate. Such trans-boundary fields will be operated in accordance with international treaties.
- Powers, rights and responsibilities are set forth for the Ministry of Energy (SENER), the Ministry of Finance and Public Credit (SHCP) and the National Commission on Hydrocarbons (CNH).
 - SENER will be responsible for: With CNH’s assistance, selection of prospective development areas based on proposals received from PEMEX and private parties
 - Granting and revocation of assignments
 - With SHCP’s participation, determination of the type of contract to be awarded
 - Development of the form of contracts and terms of tenders, with the Federal Competition Commission’s (COFECE) and SHCP’s participation at the prequalification stage
 - Approval of exploration and development programs.
 - SHCP will be responsible for:
 - Establishing the tax terms of contracts and tenders, with SENER’s participation
 - Establishing the award variables, with SENER’s participation

- Oversight of cost accounting.
- CNH will be responsible for:
 - Conducting tenders
 - Execution, administration and supervision of the contracts
 - Approval of well drilling for exploratory and deepwater wells
 - Supervision of exploration and development programs
 - Approval of seismic studies
 - Administration of sector-wide information flows.

Midstream Sector

Some highlights of the legislation for the midstream sector include:

- Open access for the natural gas market, with open seasons to be held for transportation, subject to certification and regulations issued by the Energy Regulatory Commission (CRE). Similar to the U.S. model, pipeline owners are not allowed to participate in marketing hydrocarbons. Rules are introduced to reduce market concentration of pipeline and marketing capacity over five and 10-year periods.
- A new entity, the National Center for Natural Gas Control (CENAGAS), will receive PEMEX pipeline infrastructure and initiate capacity reservation contracts with PEMEX. Other functions of CENAGAS will include administration of gas transportation and storage, development of plans for expansion and optimization of infrastructure and coordination of maintenance programs.

Downstream Sector

Some highlights of the legislation for the downstream sector include:

- The diesel and gasoline sectors will be gradually opened, with maximum price controls in place until 2019 and market pricing beginning in 2020.
- PEMEX will be the exclusive importer of gasoline until 2018.
- CRE will be responsible for issuing permits for selling gasoline and diesel to the public and transportation, storage and distribution of refined products.
- SENER will be responsible for issuing permits for oil refining and natural gas processing.

New Environmental Agency

The proposed legislation establishes a new environmental oversight body, the National Agency for Industrial Safety and Environmental Protection in the Hydrocarbons Sector (the Agency), which will act as a specialized technical agency within the Ministry of Environment and Natural Resources with managerial autonomy. The Agency is supposed to provide the following functions:

- Regulate, supervise and impose sanctions in the area of industrial and operational safety, including:
 - Adoption and implementation of national and international technical standards
 - Prevention and containment of spills and leaks of hydrocarbons
 - Contingent financial hedging (subject to approval by SENER and SHCP)
 - Physical and operational integrity of installations (including wells, platforms and pipelines)
 - Development of plans for emergency response and prevention
 - Investigation of root causes of incidents and accidents.

- Regulate, supervise and impose sanctions in the area of environmental protection, including:
 - Protection, conservation and restoration of ecosystems and natural resources
 - Waste characterization and management
 - Emission control
 - Technical assistance for the formulation and implementation of Mexico's environmental and energy policies.

In addition, the draft legislation provides that companies involved in the oil and gas industry must establish management systems aimed at monitoring and improving industrial and operational safety and environmental protection. Companies are also required to implement internal control mechanisms and conduct oversight of their regulatory compliance through external audits.

Electricity Industry Act

This proposed secondary legislation sets forth a new regulatory framework governing the electricity industry. While preserving state planning and control of the National Grid and the transmission and distribution of electricity, the legislation allows third-party participation in generation and marketing.

In the area of power generation, the proposed legislation:

- establishes conditions for free competition among all power producers

- reduces barriers to entry, facilitates new investment in clean energy and accelerates retirement of obsolete power plants
- allows power producers to enter into bilateral contracts and sell energy in a wholesale electricity market
- preserves the state's monopoly over the generation of nuclear energy
- makes the Federal Electricity Commission (CFE) a competitor on equal terms with other market participants.

Similar measures have helped usher in competitive wholesale power markets in the U.S. and have been credited with reducing cost, improving service and promoting innovation in the power sector.

The transmission and distribution of electricity will continue to be provided by the CFE, subject to a regulatory regime that will encourage the expansion and efficient operation of networks. The responsibility for designing such regulation is assigned to the CRE. In particular:

- The transmission and distribution grid will remain in the hands of the state.
- National Center for Energy Control (CENACE) will guarantee to all participants open access to the grid.
- CFE will administer, operate and maintain the grid.
- CFE will have the right to enter into contracts with third parties for the expansion, modernization, financing and operation of transmission projects as well as for the modernization of distribution zones and reduction of losses.

The proposed legal regime provides for contractual arrangements between the state and individual entities which would be able to contribute their technology and expertise to the expansion and improvement of transmission and distribution infrastructure. This will give the CFE an important tool to combat energy losses and increase the efficiency of energy delivery.

As a novel approach to market regulation, the initiative provides for the classification of energy consumers into "qualified" and "basic supply" consumers. The qualified consumers may purchase electricity from competitive suppliers in the marketplace, while the basic supply consumers will continue to be served by the CFE. To meet its basic service obligations, CFE will acquire energy from competitive suppliers through an auction process. In particular:

- CFE will provide the basic supply of electricity at regulated tariffs.
- Qualified users will be able to buy electricity from qualified suppliers or directly from the competitive electricity market.

- Qualified suppliers will be able to offer innovative pricing arrangements and services and compete with each other for customers.
- Other traders will be able to buy and sell electricity on the wholesale electricity market.

Open access to the transmission and distribution grid and the opportunity to purchase power from alternative suppliers should create the conditions for retail competition in Mexico. In the U.S., a number of states have implemented retail competition, and these initiatives have resulted in significant technological innovations and cost savings for customers.

The operational control and coordination necessary to meet energy demand at the lowest cost and provide the necessary stability to the electrical system will be conducted by CENACE. Under the legislative initiative, CENACE, as a new independent agency, will coordinate the wholesale electricity market. It will also be entitled to propose expansions of the transmission network to SENER. In particular, CENACE will:

- be responsible for the operational control of the National Grid and for ensuring open access
- ensure that the power generation facilities will produce electricity under competitive conditions
- establish clear, transparent and equitable rules to award interconnections to the electrical grid.

It appears that CENACE will perform many of the same functions as independent system operators / regional transmission organizations in the U.S. CENACE will operate the competitive electricity market where all power generators will be able to offer their production and compete under impartial rules. Energy prices will be freely negotiated between power generators, traders and qualified consumers. The Secretary of Finance will retain the right to fix the rates at which electricity will be offered to basic supply consumers. The CRE will regulate the tariffs for transmission and distribution.

The legislative initiative states that the activities of the power sector such as generation, transmission, distribution and marketing should be conducted under a strict legal separation regime in order to promote open access and the efficient functioning of the sector.

In particular, and to comply with the constitutional mandate of sustainability in the power sector, the draft of the Electricity Industry Act creates a set of obligations which will have to be complied with by qualified consumers and utility companies in order for them to be able to acquire clean energy certificates. The specific changes in the area of sustainability include the following:

- Clean Energy Certificates
 - Electricity market participants will have to meet obligatory clean energy goals in order to acquire clean energy certificates.

- The certification mechanism will allow competition among clean energy sources utilizing various technologies in different geographic locations such that the required goals are achieved with minimum expenditures.
- Interconnection and transmission for clean energy sources
 - Clean energy producers will be allowed to interconnect to the grid without delays and surcharges.
 - New infrastructure planning will be conducted taking into account the need for power evacuation from the areas of high potential for renewable energy generation.
- Distributed generation
 - Under the new regulations, consumers that have installed solar panels or other power generation equipment will be able to obtain interconnection on an expedited basis.
 - Such consumers will be able to sell extra energy to CFE at regulated rates, and to other power suppliers, at market prices. In the U.S., similar policies, known as “net metering,” have been very successful in promoting the installation of distributed generation resources.
- Smart and controllable demand
 - Reductions in demand will be used as a substitute for generation, with resulting savings in energy and costs.
 - Under the controllable demand regime, consumers will be able to receive credit for reduction of power consumption in peak time periods. This is similar to “demand response” programs in the U.S. which have been successful in reducing peak load, which in turn reduces the need for expensive new generation capacity.

The draft legislation for the Electricity Industry Act also proposes the creation of a Universal Electrical Service Fund to finance electrification in rural and marginalized urban communities. Among other sources of income, the fund will accumulate surpluses resulting from the management of energy losses in the electricity market.

Geothermal and Water

A newly proposed Geothermal Energy Act is intended to regulate the prospecting, exploration and production of geothermal resources for electric power generation or various other uses.

In terms of installed geothermal capacity (about 840 MW), Mexico ranks fourth worldwide, only behind the United States, the Philippines and Indonesia. Mexico's geothermal potential is estimated at 10 GW.

The draft Geothermal Energy Act envisions the following phases of geothermal activity and respective regulatory regimes:

- Prospecting: A registration for eight (8) months without intrusive activities
- Exploration: A permit for three (3) years (extendable) for an area of up to 150 sq. km.
- Production: A concession for up to 30 years (extendable) for an area of up to 150 sq. km.

The draft Geothermal Energy Act also includes a proposal under which CFE will be tasked to propose to SENER, within 120 days after the entry of the law into force, a “Round Zero” list of prospective geothermal areas to be considered for the granting of permits or concessions. In addition, CFE will be allowed to form public-private partnerships or hold tenders for the development of geothermal projects.

In addition, the proposed legislation would amend the National Water Law to create a distinction between the sources of geothermal water (whose development will be regulated by SENER) and conventional aquifers (whose development will continue to be regulated by the National Water Commission (CONAGUA)).

Looking Forward

With the recent re-appointment of Juan Carlos Zepeda as commissioner of the CNH, we anticipate that CNH will continue to press forward with the development of licensing regimes for oil and gas exploration, both as an extension of PEMEX’s rights from Round Zero, but also for private participation as well. The CFE will likely continue efforts to prepare to be a ‘productive’ company, and without some of the particular protections that were granted to PEMEX (including guaranteed participation in transboundary fields, and the ability to take assignments of certain areas in Round Zero and Round One). The future seems extremely bright for Mexico and the progress of its efforts to spur foreign direct investment in the energy sector.

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