The Metropolitan
Corporate Counsel®

National Edition www.metrocorpcounsel.com

Volume 22, No. 10 October 2014

The Future Of Mexico's Energy Industry

*The Editor interviews **Steven P. Otillar**, Partner at Akin Gump Strauss Hauer & Feld LLP.*

Editor: Please describe your practice, and tell us why Mexico is high on your radar screen.

Otillar: My practice focuses on domestic and international energy transactional work, with an emphasis on upstream acquisitions, divestitures and development. I have represented energy companies and private equity funds with significant equity and asset acquisitions and divestitures in the U.S. and abroad for almost 20 years. In addition, I have helped clients with a variety of project development and finance arrangements for energy projects and infrastructure. I have led and worked on project teams for the development and finance of pipelines, wind power projects and natural-gas-fired plants in the U.S., Mexico and Brazil. Other notable experience includes the negotiation of host government granting instruments (that is, the rights to explore and extract hydrocarbons), and farm-in and farm-out arrangements relating thereto literally around the world in a variety of emerging markets.

Regarding Latin America and Mexico in particular, I began working there early in my career after having studied in Mexico during summers in college and law school. My professional interest has remained steady through the 2001 reforms with multiple service contracts, the 2008 reforms with integrated services contracts and now, of course, the Constitutional reforms passed in 2013. While this legislation has created a sudden interest in Mexico that has been quite shocking to some, it really was anticipated by those of us who have been watching these developments all along. I liken it to a rock band that after 15 years of playing small venues, suddenly becomes an "overnight success."

Akin Gump
Strauss Hauer & Feld LLP


Steven P. Otillar

Editor: Please describe the monopolistic position of Pemex in Mexico on a historic basis.

Otillar: In the 1800s, Mexico and the U.S. had similar legal regimes that allowed land owners the right to own the mineral estate beneath the surface. Mexico's 1917 Constitution – and the infamous Article 27 – granted the state complete ownership and control of subsoil mineral interests, and in 1938, the Mexican government nationalized all oil and gas assets. Since such time, Pemex has operated as a monopoly. Interestingly, Article 27 was amended in the 1940 Petroleum Law and again in 2013, but, in all cases, state ownership was affirmed.

Current changes to the Constitution and secondary legislation provide the ability for companies to receive compensation in-kind for oil and gas exploration activity in Mexico, and to hold economic interests on hydrocarbons that are produced. Oil and gas concessions allowing foreign companies to acquire rights in oil and gas produced actually existed under Article 27 of the Constitution and the 1940 Petroleum Act; however, President Ruiz Cortines reformed the Petroleum Act on the last day of his presidency in 1958 to prevent any sort of production sharing between private companies and Pemex.

From that point, Pemex was allowed to engage private companies only under service contracts, and international exploration and production (E&P) company participation in Mexico's upstream market effectively ended. For the next 53 years, Pemex handled the development side, entering into service contracts as needed for drilling and geological/geophysical work. The 2013 reforms took us back 75 years, i.e., before the nationalization, and opened up the market to full participation. As a result, Pemex is no longer a mandated state monopoly.

Editor: Why has Pemex and Mexico's oil production suffered in recent years?

Otillar: Oil production in Mexico has declined over 25 percent in the last decade. Pemex executives might blame government-imposed restrictions, including an inability to set their own budget, plus the fact that their revenue is attributed to the general treasury and the operation of the federal government. These operational "handcuffs" prevented Pemex from investing in exploration and development. Others have cited the inefficiency of Pemex and its inability to find new fields.

Putting blame aside, there is no doubt that, as an international E&P company, Pemex did not reinvest enough in exploration, development and technology. The situation became grave during the last five or six years, being unable to avoid negative reserve replacement as Pemex faced significantly increasing demand and decreased domestic production. Further, Mexico's status as a significant importer of U.S. gas has only exacerbated the impending energy crisis. These factors provided the impetus for the "Pacto de Mexico" that was established by President Peña Nieto in the early part of his administration and the resulting energy sector reforms.

Editor: Describe the enactment of Mexican laws aimed at opening up exploration and production in the hydrocarbon industry.

Otillar: Amending the Constitution has been an absolute revolution, one that many colleagues thought would never happen. My own view was that amendments to the Constitution to end protection of *ejidos* (that

Please email the interviewee at sotillar@akingump.com with questions about this interview.

is, communal agrarian land ownership) in 1991 set the stage for changes to the other pillar of the Mexican Revolution: oil and gas. The 2013 Constitutional reforms will give Mexico the tools to generate global competition for oil and gas exploration and production rights, similar to what we see on the U.S. side. The changes are truly transformational, as Pemex itself now will be tasked with becoming a productive enterprise. Virtually everything is going to change in the energy sector in Mexico in the medium term.

Editor: Please discuss the regulatory structure. Is there the risk that a top-heavy regulation may dampen entrepreneurial efforts?

Otillar: That's an important question. While the regulatory structure remains a work in progress, the bones are in place and moving forward. The Ministry of Energy, SENER, is responsible for regulating the energy sector. Once subordinate to SENER, the National Hydrocarbon Commission (CNH) and the Energy Regulatory Commission (CRE) have been redefined pursuant to the reforms, and they exist as independent executive entities at the same level as a cabinet secretary. This sets up an interesting dynamic as to the agencies' interrelationship and how they will continue to regulate. There's an ad hoc commission called the CCSE that will coordinate their activities, but it will be a completely new regime.

In my experience, the structure already is working well, but it is not without its challenges. The CNH provides expert advice to SENER in the upstream space, and they are the upstream regulators, responsible for signing and managing the host government granting instruments with Pemex or with independent oil and gas companies. The CRE will regulate midstream activities involving the transportation of hydrocarbons.

Briefly, in other areas, the regulatory structure for environmental issues is still developing and will include the National Agency for Industrial Safety and Environmental Protection (ANSIPA). The Ministry of Agrarian, Territorial and Urban Development (SEDATU) will regulate land use and occupancy. The Secretariat of Finance and Public Credit (SHCP) will set the fiscal terms and conditions for each contract. Overall, we are seeing a concerted effort to create a transparent system that is divorced from political influence, one that will give confidence to the international market through enforceable rules and a fair bidding process.

There is a risk about top-heavy regulation because, for example, each of the agencies reports directly to the Office of the President. On the positive side, the commissioners and the director of the commissions serve five-year terms, and Juan Carlos Zepeda, the first director of the CNH, was recently re-appointed for a second term. Presumably, if the government wanted a political appointee, it would have taken that opportunity, instead of keeping an experienced director who has really carried the Mexican flag internationally to create a strong regulator.

Editor: What is the role of Pemex under the new regulations?

Otillar: Both Pemex and the CFE have been asked to become productive state enterprises, which means they will have budgetary authority and operational control. Ultimately, they will pay royalties, taxes and fees similar to what private companies and market participants are obligated to pay.

Right now, Pemex is going through a transition. It has identified "round zero" properties that it wants to retain privately and operate, and it is working with SENER to define the terms and conditions, or *asignaciones*, that will govern those property rights.

Pemex also has identified areas in which it would like to partner with independent oil and gas companies (IOCs) in areas such as deep-water, unconventional resource plays and shallow waters. Apart from these, and the possible migration of existing contracts awarded by PEMEX pursuant to the 2001 and 2008 reforms, Mexico will proceed with open bidding rounds where Pemex and other IOCs will compete. The areas to be put up for tender in "round one" have been identified, and the bidding round to approve Pemex partners and to auction new areas should occur next year.

Editor: Tell us about the resulting flow of funds and revenue-sharing regimes with the IOCs.

Otillar: Cash flow will depend on the nature of the funds, and SENER will determine the contracting model to use for each block, with fiscal terms set by SCHP. In addition to land-use fees and bonus payments, royalties and production sharing will provide additional revenue to the state. Royalties will start at 7.5 percent and increase depending on the price of oil. A similar regime is being established for natural gas. Taxing authorities certainly will get their revenue as well. The form of contract used will be a determining factor, so, for instance, farm-out contracts that migrate to joint ventures surely will run through Pemex. Licenses, on the other hand, would require the royalty payments to be paid to the state.

The existing legislation authorizes several forms of model agreements, including production-sharing contracts, licenses, risk service agreements and profit-sharing contracts. Concessions are not allowed, and that's an interesting legal point because of the similarities between licenses and concessions in the upstream space. Under a license, the government will be compensated by bonus payments and royalties. Under a production-sharing contract, the government will receive bonus payments, royalties and a share of profit that oil produced after cost recovery by the IOC. Profit-sharing contracts will be similar, but the IOC and the state will share profits, not oil and gas production. Under risk service contracts, the IOC should expect to receive a fee per barrel produced.

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Editor: What changes will Pemex undergo to become a productive state enterprise?

Otillar: Pemex will begin to act more like an IOC, using the foundation of its existing E&P rights to become a competitive enterprise. It will enter into joint operating agreements with enterprises that have desired technology, resources and expertise, enabling Pemex to enhance efficiencies and its decision-making process. Initially, Pemex will not likely be an operator in deep water operations, but, over time, I imagine that it will assume operatorship. Pemex is obligated to set and publish a five-year business plan, which I anticipate will include the development of resources internationally as well as domestically.

Editor: You mentioned that round one for foreign company bids is scheduled for next year. Have any companies expressed an interest in bidding?

Otillar: Round one may occur as early as May of 2015, which is ambitious but not far off. There are two key components of the bid round. The first is that Pemex joint venture partners will be approved in the bidding round because the laws indicate that the CNH must award contracts to Pemex partners at this stage pursuant to a bid. The second component of round one will be an open bid round for a number of blocks identified by the government.

We have clients and are aware of many international companies that are extremely interested in participating. Some companies have maintained offices in Mexico for years waiting for this day. Almost everyone, from local Mexican companies to well-known NOCs like Statoil, to all the majors and major independents, is anxious to work in Mexico.

Pemex has already signed a number of accords, and several potential partnerships have been announced in the media. Known players include ExxonMobil, Statoil and Shell, and it's clear that many more companies will be interested in bidding individually.

Editor: What types of partnership regimes do you expect Pemex will adopt?

Otillar: The updated legislation allows Pemex autonomy with regard to its budget and the creation of subsidiaries and partially owned subsidiaries that will be joint venture entities. We will see Pemex signing contractual joint ventures under a typical JOA (joint operating agreement) form, and there will be opportunities for equity joint ventures that involve co-ownership similar to Pemex's ownership of Gasoductos de Chihuahua, a natural gas transportation joint venture that it owns with Sempra Energy.

Editor: What effect will the opening up of the oil monopoly have on foreign investment in Mexico?

Otillar: Looking at the numbers, Pemex has been investing about $25 billion a year in upstream exploration development, and Mexico has expressed an immediate need for $60-plus billion per year to develop new fields and maintain the pace of energy and hydrocarbon production. That's the real driving force behind the recent, dramatic reforms.

Pemex doesn't have that kind of money, even post-reforms, so this money is expected to come from foreign investment, meaning IOCs that will invest in building roads and pipelines, hiring and training local people and bringing in expats. Growth in Mexico could be similar in nature to what we experienced in the U.S. with the shale revolution.

Editor: Give us some final thoughts on a tantalizing question: Will it work?

Otillar: Certainly, we can expect some growing pains with agencies like the CNH, which has been in existence only since 2008. We can also take some lessons from Brazil, where the enthusiasm of international investors and the injection of significant capital into the initial bidding rounds was dampened by the immaturity of governmental institutions, which couldn't pass environmental regulations and generally lacked coordination.

The short answer is that success is up to Mexico, but I think it will work. They have placed the right people in the executive branch, in Congress and on the regulatory side, and based on my substantial experience working in Mexico, I see a viable commitment to change.

It's going to take a lot of work, but I would bet on Mexico.