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## **Mexico Takes a Decisive Step and Approves Significant Energy Reform**

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After almost five months of political analysis and debate at the Mexican Congress, following each of the three major Mexican political groups' submission of their own energy reform bill, on December 11, 2013, the majority of the Mexican Senate approved the energy reform bill (the "Bill"), which was later passed by the lower chamber of the Mexican Congress on December 12, 2013 and is expected to be promptly ratified by the required simple majority of the Mexican states' congresses. The Bill is expected to be published at the Federal Official Gazette shortly thereafter, at which point it will become valid law.

The Bill completely overhauls Mexico's energy sector (the "Sector"), its related activities and the state-owned entities that currently monopolize almost all of the Sector's activities. Among other significant amendments, the Bill comprises the lifting of historic bans and restrictions on private investment in certain activities of the Sector and the introduction of international industry practices such as the booking of reserves and the restructuring of the state-owned *Petróleos Mexicanos* ("PEMEX") and the Mexican *Comisión Federal de Electricidad* ("CFE"), reason why Mexican and international energy players were widely following it, and expecting it. These amendments have a clear goal of opening and upgrading the Sector to attract domestic and foreign investment, know-how, technologies and methods, which would certainly boost the Mexican economic growth on the following years.

The Bill is principally based on the reform bills presented in July and August of 2013 by the right-wing *Partido Acción Nacional* ("PAN") and by the President of Mexico, Mr. Enrique Peña Nieto, backed by his own party, the *Partido Revolucionario Institucional* ("PRI"). We at JATA consider this Bill an enormous step for Mexico in the political and economical sectors, besides the significant investment that such amendments will definitely drive; for such reason, and to provide factual information to our clients and friends, we have prepared a summary of the most significant characteristics of the Bill:

### **I. Basics.**

The Bill amends articles 25, 27 and 28 of the Mexican Constitution to allow the private sector's involvement in the energy industry's activities, as detailed below; it also contains twenty-one provisional articles that further specify, among other things: (i) the means to achieve such private sector's involvement, (ii) the process by which the State-owned companies will be transformed into "productive" State companies, (iii) the formation of new governmental regulatory bodies, and (iv) the special regulations that shall be implemented and/or modified for such purposes.

## **II. Oil and hydrocarbons.**

Article 27 of the Mexican Constitution is amended in order allow the involvement of private companies and/or individuals in the activities of exploration and exploitation of oil and hydrocarbons. Furthermore, the amendments to Article 28 carve out activities related to oil, hydrocarbons and basic petrochemicals as Constitutional monopolies of the State.

### **a. Private sector's involvement in oil and hydrocarbons' related activities.**

The new constitutional text provides that the Mexican State may either: (i) assign in favor of the "productive" State companies (PEMEX or subsidiaries) the rights to perform oil and hydrocarbons' related activities (this is known as the "Round Zero" in favor of PEMEX); or (ii) enter into contracts with PEMEX or any private parties for the same purposes. Moreover, it also allows PEMEX to enter into contracts or joint ventures with private parties for the performance of its activities, and it can also request for its current contracts to be transformed into other type of contracts, in which the private sector may participate.

Private parties may also participate, through permits granted by the Mexican regulatory bodies, in the activities of oil treatment and refining; natural gas processing; storage, transportation and distribution of oil, gas, oil resources and petrochemicals – a huge amendment.

### **b. Contractual framework and private sector's profit.**

After many discussions, the provisional articles of the Bill detail that the contractual framework to be further detailed in a subsequent Regulatory Law shall include, among others: (i) service contracts, (ii) profit-sharing contracts, (iii) production-sharing contracts, and (iv) licenses for the performance of exploration and exploitation activities on behalf of the State. The State will decide which of the abovementioned options is most suitable for any particular case, in order to capitalize its own profits.

The fees to be paid to private entities for their services will also be decided by the State, but shall include the following methods of payment: (i) cash, for services contracts; (ii) a profit percentage, for profit-sharing contracts; (iii) a percentage of the output production, for production-sharing contracts; (iv) the transmission of the extracted hydrocarbons' ownership (after the payment of any applicable fee or tax), for licenses, or (v) any combination of the foregoing.

### **c. Booking of reserves.**

As highly expected by private investors and global energy players (and critical, from a financial standpoint, for the energy reform's expected successful outcome), the Bill provides that private entities entering into contracts with the State or with PEMEX, may report for accounting and financial purposes the corresponding assignation or contract and their expected benefits, with the single condition of asserting that the ownership of the oil and hydrocarbons belongs to the State.

The termination of the restriction over this international practice will surely be well-received by the investors who are overlooking the Sector.

### **III. Electricity sector.**

The Mexican electricity sector's activities are currently monopolized by the CFE and only the electric generation via electric auto generation, cogeneration, IPP and small generation is allowed to the private sector. The amendments to Articles 27 and 28 of the Mexican Constitution, along with the dispositions of the provisional articles of the Bill, significantly modify and open the electricity sector to the participation and investment of private entities, by limiting the State's role as a public service provider to the activities of electricity transmission, distribution, and the planning and control of the national electric system.

#### **a. Private sector's involvement in the electric sector's related activities.**

The Bill lifts the restriction placed against the private sector on the generation of electricity by removing the condition of such activity as a public service. As a consequence, private entities are expected to be able to fully participate and compete in the electricity generation in a free market environment.

Moreover, the State will preserve its exclusive role as a public service provider of electricity's transmission and distribution. The provisional articles of the Bill provide that private entities may enter into contracts with the State for the financing, installation, maintenance, managing, operation and expansion of the infrastructure needed for such public service.

#### **b. Contractual framework and private sector's profit.**

New regulatory laws shall be implemented in the following months with the purpose of regulating the contractual framework applicable to the private sector's involvement at the activities mentioned above and to regulate the electricity wholesale market.

### **IV. Reorganization of Mexican governmental bodies.**

As endorsed in their respective reform bills by the PAN and by the left-wing *Partido de la Revolución Democrática* ("PRD"), the Bill involves changes to the operation and activities of the Mexican state-owned companies and regulatory commissions, as well as includes the creation of new commissions. Once enacted, the Bill will produce the following changes:

- PEMEX and CFE will be transformed from state-owned companies into productive State companies, competing in the marketplace with new objectives, management and corporate governance structures;
- The Mexican Ministry of Energy will be in charge of assigning, under certain conditions and proceedings, the exploration and exploitation rights of the Round Zero to PEMEX, as well as designing the contracts and the guidelines for the public biddings of contracts and granting of permits for the activities of oil treatment and refining, and for the natural gas processing. Regarding electricity, it will oversee the operation of the sector;
- The National Hydrocarbons Commission will provide technical assistance to the Ministry of Energy; it will manage the public biddings of contracts, awarding and executing contracts with private entities, and it will oversee and regulate the exploration and exploitation of hydrocarbons;
- The Energy Regulatory Commission will now regulate and grant permits for the storage, transportation and distribution of oil, gas, oil resources and petrochemicals,

as well as regulate the sale of such products. Regarding electricity, it will grant and regulate the permits to private entities for electricity generation and the fees for transmission and distribution of electricity;

- The creation of the Mexican Oil Fund for Stabilization and Development (*Fondo Mexicano del Petróleo para la Estabilización y Desarrollo*), a public trust responsible for receiving, managing and distributing any revenue of the aforesaid contracts and assignments;
- The creation of the National Center of Natural Gas Control (*Centro Nacional de Control del Gas Natural*), which will be responsible for operating the Mexican pipeline network, acquiring the contracts and rights of PEMEX in that area;
- The creation of the National Center of Energy Control (*Centro Nacional de Control de Energía*) which will be responsible for operating the national electric system, the electric wholesale market, the free access to the transmission and distribution grids, mostly in substitution of the CFE, and
- The creation of the National Agency of Industrial Security and Environment Protection of the Hydrocarbons Sector (*Agencia Nacional de Seguridad Industrial y Protección al Medio Ambiente del Sector Hidrocarburos*) which will be responsible for regulating and overseeing the activities of the sector, the waste disposal and the protection of the environment.

#### **V. Execution of the Bill.**

Once approved by the simple majority of the Mexican legislatures and published at the Federal Official Gazette, the following terms will commence:

- 90 calendar days for PEMEX to evidence its exploration and extraction capacity to the Mexican Ministry of Energy, and request the assignment of exploration areas and extraction fields;
- 120 calendar days for the Mexican Congress to enact the secondary laws that may be necessary to: (i) regulate the legal and contractual frameworks related to the oil and hydrocarbons' sector, and to the electricity's sector; (ii) establish the minimum guidelines and percentages of national participation in the assignments and contracts; (iii) perform the necessary operative and management changes to the current regulatory entities; (iv) create the National Agency of Industrial Security and Environment Protection of the Hydrocarbons Sector; (v) set the guidelines for the transformation of PEMEX and CFE into productive State companies; and (vi) create the framework for the anti-corruption supervision at the Sector;
- 12 months for the Mexican Congress to promote, by amendments, the use of clean energies, efficiencies and better practices at the Sector, and throughout the year 2014 for the formation of the Mexican Oil Fund for Stabilization and Development (*Fondo Mexicano del Petróleo para la Estabilización y Desarrollo*);
- 12 months for the Mexican Congress, after the enactment of each corresponding Regulatory Law, for the formation of the National Center of Natural Gas Control and the National Center of Energy Control, and

- Two years, as a maximum limit, for the effective transformation of PEMEX and CFE into productive State companies.

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