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## **The Mexican Energy Reform: Three Years After.**

by Carlos A. Chavez.

December 20, 2016, marks three years since the Mexican Government enacted the constitutional overhaul that laid out the foundations of what we know as the Mexican Energy Reform. Three articles of the country's Constitution were amended, effectively lifting bans and restrictions placed on private investment in almost all of the activities of the energy sector, also paving the way for the restructuring of both Pemex and CFE, the state-owned utilities that largely monopolized the sector in the country. The constitutional reform was shortly followed by a series of federal laws that expanded the reach of the reform and, to this day, additional and more detailed rules and guidelines are frequently introduced, providing a clearer outlook for the energy industry in Mexico.

These three years have brought up not only revisions to the Mexican energy regulatory framework, but the business environment and the infrastructure sector have also experienced long overdue changes, leading Mexico to the international scene, and international players into Mexico. The process of implementing the reform has led the Mexican Government to cope with internal and external shocks; some of them positive, such as the immense growth of the global renewable energy industry in the past couple of years, as well as negative ones, such as the decline of the international crude oil prices. Overall, we are currently watching how both the Mexican oil & gas and the electricity sectors are gradually being shaped by actions taken by the Mexican government and by the new players that are entering those formerly restricted industries.

The creation of a new vibrant energy industry in Mexico has happened in a rather rapid fashion, leading to potential confusion on the current status of the regulatory framework and the actions that have already been implemented. With the intention of shedding light on this topic, we share with you a list of the most important developments that have happened within the past three years in Mexico's new energy sector:

### I. Oil & Gas Sector

#### a. Upstream Sector

- i. In the first action that shaped Mexico's new upstream sector, the Mexican Ministry of Energy ("SENER") assigned directly in favor of Pemex, through *Ronda Cero*, the rights to continue performing E&P activities in all the fields that it was producing up to the promulgation of the Energy Reform and the fields where it had made commercial discoveries or substantial investments prior to the reform. Pemex was granted the additional right to request the migration of this entitlements into E&P contracts in which private companies may take an interest and the right to farm-out its interests in such fields.
- ii. Throughout 2015 and 2016, the National Hydrocarbons Commission ("CNH") held the first four tenders or phases of the so-called *Ronda Uno* bidding process, successfully awarding: (i) two out of the fourteen production-sharing agreements for E&P at shallow water blocks auctioned in Phase I; (ii) three out of the five production-sharing agreements for E&P at shallow-water fields auctioned in Phase II; (iii) all the 25 available license agreements for production of mature conventional onshore fields in Phase III; and (iv) eight out of the ten deep-water areas auctioned in Phase IV, as well as successfully getting Pemex its first partner via a farm-out of a deep-water block. Much of the success of the auctions was attributed to

the series of revisions performed by Mexican authorities to the bidding documents and the auctioned agreements, in response to the industry's demands. Following the success of *Ronda Uno*, the first three phases of Round Two (*Ronda Dos*) have been called and scheduled for 2017, and Pemex has announced new farm-outs of shallow-water and onshore fields.

- iii. The core activities of the sector are regulated by the Federal Hydrocarbons Law (*Ley de Hidrocarburos*) and its regulations (*reglamento*), but additional regulations have been issued by the authorities that further govern the actions that must be followed by the sector's participants; among the most important we identify the following: (i) Regulations on Permits for Surface Surveying and Exploration of Hydrocarbons; (ii) Hydrocarbons Measurement Guidelines; (iii) Guidelines and Model Contracts for the Negotiation between landowners and contractors; (iv) Minimum National Content Guidelines; and (v) Well Drilling Guidelines.
- b. Midstream & Downstream Sectors
- i. Prior to the enactment of the Energy Reform, both midstream and downstream activities were, to some degree, open to the participation of private entities in their respective supply chains, although always tied to Pemex. The new regulatory framework completely opened all activities to private parties, with an ongoing unbundling of such activities from Pemex's shadow, through the application of several schemes.
  - ii. For the midstream sector, the National Center for Natural Gas Control ("CENAGAS") was created and is now the operator of the Mexican pipeline network, receiving from Pemex all of its natural gas midstream assets. CENAGAS, along with other Mexican agencies, is managing the aggressive expansion of the country's national pipeline network, which has grown considerably and is projected to double the size it had prior to the Energy Reform within the next couple of years.
  - iii. The downstream sector is also being reshaped rapidly and ahead of the original schedule by the Energy Regulatory Commission ("CRE"). Due to the complexity inherent to the various correlated markets, the authorities initially designed an implementation period for the opening of the activities, including the liberalization of prices. Retail sale and import/export of gasoline and diesel are now allowed and completely open to competition, no longer tied to the exclusive supply by Pemex. Starting on January of 2017, retail prices of gasoline and diesel will no longer be determined by the Government; LPG will follow a similar process starting on 2017. In 2016, Mexico welcomed new players in this industry, such as *Gulf Oil*, *Nexxum*, *Oxxo Gas*, *Petro Seven* and *Chevron*, among others.
  - iv. Key regulations that have been enacted on these sectors include the following: (i) Regulations on the Storage of Hydrocarbons and Transportation by Pipeline; (ii) Regulations on the Marketing and First-Hand Sales of Hydrocarbons, Oil Products and Petrochemicals; (iii) Regulations on Open Access to midstream and downstream networks; (iv) Measurement Guidelines; and (v) Guidelines on Industrial Safety and Environmental Protection.

## II. Electricity Sector

- a. The Mexican State's role in the electricity sector was significantly reduced and now limited to that of an independent operator of the national grid through the National Center for Electricity Control ("CENACE"), and as a public service provider of the activities of electricity transmission and distribution, through the restructured CFE and its newly created subsidiaries.
- b. In the last quarter of 2015, SENER created the Mexican Wholesale Electricity Market (the "WEM"), a spot market similar to PJM, CAISO and NYISO. In the WEM, the power generators, marketers and qualified consumers that participate in it can enter into purchase and sale transactions of electricity, ancillary services (including regulation reserves, spinning reserves, non-spinning reserves and supplementary reserves), capacity, financial transmission

- rights and clean energies certificates. Most of the sub-markets of the WEM are already operative, while the others are being gradually tested and implemented.
- c. Also in 2015, the Energy Transition Law was enacted, setting the strategy for the attainment of the country's goals in the use of clean energies and energy efficiency. Mexico set an ambitious goal of generating 25% of its electricity from clean sources by the year of 2018 and the threshold for qualified consumers is of 5% of aggregated consumption starting on 2018 and such target will gradually increase.
  - d. During 2016, CENACE held the first two long-term auctions of electricity, power and clean energy certificates. The results of these auctions exceeded the original expectations, providing its off-taker, the CFE as basic service supplier, with more than 80% of the energy, capacity and clean energy certificates it requested, mostly from renewable energy projects.
  - e. Similar to the expansion of the pipeline network, Mexico's national grid is set for a large expansion and the first steps have been taken by the Federal Government to accomplish such feat. In the last quarter of 2016, CFE called for the country's first tender for the construction of an HVDC transmission line.

In addition to these actions, the Energy Reform has brought changes to other related areas that may be impacted by the projects of the new private Mexican energy sector. These changes include amendments to the framework that regulates the use of land and the social impact that these projects may have in the communities, the introduction of a new federal anti-corruption framework, as well as the launching of investment vehicles specifically tailored to promote energy projects, such as the Fibra E and the CerPIs.

Please send any comments or questions to [info@jata.mx](mailto:info@jata.mx). The author is a Senior Associate of JATA – J.A. Treviño Abogados. JATA is a Mexican law firm with offices at Monterrey, Mexico and Houston, Texas.

Please do not hesitate to contact us with any comments or concerns regarding Mexico's energy reform and its implementation in practice.

December 20, 2016.



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