

MEXICO'S ENERGY REFORM PROVIDES SIGNIFICANT OPPORTUNITIES IN OIL AND GAS EXPLORATION AND PRODUCTION

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Mexico's new energy legislation, which went into effect on August 12, 2014, will completely restructure the Mexican energy sector, including both hydrocarbons and electricity. This legislation opens up oil and gas exploration and production ("E&P") to the private sector, through authorization of new contract arrangements with the Mexican State or with PEMEX, while reaffirming Mexico's ownership of hydrocarbons in the ground. Mexico's opening to the private sector will generate numerous opportunities for E&P operators, the E&P arms of international oil and gas companies, suppliers, and investors.

contracts, together with license agreements where the E&P contractor can retain the extracted hydrocarbons. The initial opportunities for the private sector in oil and gas E&P will derive from potential joint ventures with PEMEX. There will be subsequent opportunities presented by open bidding for oil and gas resources identified by the Mexican Ministry of Energy (*Secretaría de Energía*, or "SENER").



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The new legislation—a package of 21 new laws and amendments to existing statutes known as the Secondary Laws—implements the reforms to the Mexican Constitution on energy that were promulgated in December 2013.

Under the transitional provisions of the decree promulgating the constitutional reforms on energy, PEMEX was granted a "Round Zero" whereby it could request first rights to specified hydrocarbon areas for its own exploration and production, and SENER would make a final determination on the rights to be granted to PEMEX. On August 13, 2014, SENER announced its determination that PEMEX would receive Assignments of (1) 83 percent of Mexico's 2P reserves (proved and probable) and (2) 21 percent of prospective resources. According to SENER, this gives PEMEX a secure future for the next 20.5 years, corresponding to five years of exploration and 15.5 years of production.



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Regarding oil and gas, the Secondary Laws open up exploration and production to the private sector, through authorization of new types of contract arrangements with the Mexican State or with PEMEX (Mexico's state-owned oil and gas company), while reaffirming the State's ownership of hydrocarbons in the ground. The new contract arrangements will include production-sharing and profit-sharing

For the private sector, there is a silver lining to the extensive oil and gas resources granted to PEMEX

by means of the Round Zero Assignments. PEMEX will be able to “migrate” these Assignments into contracts, and then enter into joint ventures with the private sector to explore and develop the corresponding areas under such contracts. In each case, the selection of the private sector partner will be done through a bid process, but PEMEX will be able to shape that bid process for the benefit of its preferred partners.

Following PEMEX’s Round Zero, the remaining hydrocarbon resources of the country will, in due course, be subject either to (1) further Assignments granted to PEMEX, if SENER determines that this would best serve the interests of the State as to production and the guaranteed supply of hydrocarbons, or (2) E&P contracts granted to the winners of tenders, in which both PEMEX and the private sector will be able to participate. In such tenders, permitted bidders will be able to bid individually, in consortia or through contractual partnerships. Because of the scope of the Assignments granted to PEMEX in Round Zero, SENER will probably favor the use of tenders for E&P contracts going forward, rather than Assignments, at least for the next several years.

The Mexican government has announced that the anticipated tenders for E&P contracts, referred to as “Round One,” will be combined with the bid process to select JV partners for 10 PEMEX projects following PEMEX’s migration of certain of its Round Zero Assignments to contracts. The stated rationale for combining the two bid processes is to allow the private sector to make better investment decisions by evaluating all

the PEMEX JV opportunities and the Round One opportunities together.

The Pemex JVs and the Round One E&P contracts are expected to be awarded starting in April or early May 2015, and continuing through September 2015. The JV contracts and the Round One E&P contracts will not all be awarded at the same time, and shallow water projects will be awarded before deep water projects.

The Secondary Laws present opportunities to the private sector both in terms of JVs with PEMEX and direct bidding for rights over hydrocarbon resources not assigned to PEMEX. E&P operators, the E&P arms of international oil and gas companies, suppliers and investors will all want to explore these opportunities in depth.

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In order to present the major changes to Mexico’s oil and gas sector under the Secondary Laws, in particular as to upstream activities, and how such changes unlock opportunities for the private sector, this article provides:

1. A commentary on the current status of oil and gas E&P in Mexico, and the challenges to Mexico’s energy competitiveness under pre-reform conditions.
2. An overview of opportunities for the private sector in oil and gas E&P under the Mexican Hydrocarbons Law (*Ley de Hidrocarburos*), one of the key Secondary Laws.¹
3. A discussion of the new PEMEX under the PEMEX Law (*Ley de Petroleos Mexicanos*) and the other Secondary Laws.

4. A review of the role of the regulators in oil and gas E&P under the Secondary Laws.
5. A summary of the national priorities that will be advanced under the Secondary Laws and how those priorities affect the regulatory structure for oil and gas E&P.

The Challenges Currently Affecting Oil and Gas E&P in Mexico

Prior to Mexico’s constitutional reforms on energy, oil and gas E&P was reserved to the State and carried out solely through PEMEX, with a limited supporting role for the private sector. That supporting role consisted of providing E&P-related services to PEMEX under service contracts, which allowed for fixed payments and limited incentive compensation to the private contractor. However, private companies could not enter into production-sharing or profit-sharing arrangements or license contracts (to retain extracted hydrocarbons) with the Mexican State or with PEMEX, due to constitutional limitations.

For many years, PEMEX’s monopoly in oil and gas E&P worked satisfactorily for Mexico. However, over the last decade production of oil declined and production of natural gas did not keep up with the nation’s needs, particularly for generation of electricity. Accordingly, PEMEX’s E&P monopoly came to be viewed as an impediment to development and to Mexico’s competitive position in the world economy.

PEMEX’s production of oil dropped from 3.4 million barrels per day (mbpd) in 2004 to 2.5 mbpd in 2013. PEMEX recently reduced its output forecast for 2014 to 2.44 mbpd. In addition, Mexico’s reserves fell by 23 percent between 1999 and 2012, and

then a further 1 percent between 2012 and 2014. Indicative of this decline, Mexico's "super giant" Cantarell oil field, in the Bay of Campeche, was Mexico's largest oil field for many years, but its daily production has declined 81 percent over the last 10 years. Other oil fields have not made up the difference. The Mexican Senate report on the Hydrocarbons Law averred that the decline of the Cantarell oil field "marks the end of readily accessible oil for Mexico," i.e., oil that can be produced easily and cheaply.

The report further stated that future petroleum production would, in large part, derive from shale beds and deep waters. A PEMEX E&P presentation from March 2014 shows an estimated 31.9 billion barrels of oil in Mexican shale beds and another 26.1 billion barrels in deep water. However, PEMEX by itself lacks the capacity – technical, financial and operational – to take full advantage of these natural resources.

With respect to natural gas, Mexico in 1997 was close to self-sufficiency, importing only 3 percent of national consumption. Currently, it imports 30 percent. Mexico has significant natural gas resources. Among other things, PEMEX estimates that the natural gas in Mexican shale beds amounts to 36.8 trillion cubic feet (tcf) of wet gas and 104.7 tcf of dry gas, equivalent to 28.3 billion barrels of oil (not including shale beds in Chihuahua, immediately south of Texas, now under study). But PEMEX has not been able to take advantage of these resources.

PEMEX clearly has technical, financial and operational limitations on its ability to pursue shale gas. But

another issue is that PEMEX has given a higher priority to petroleum than to natural gas, because oil is much more profitable to PEMEX than gas. Yet even as the country needs more natural gas, no company other than PEMEX could provide it because of the previous constitutional restriction against private sector participation in production of this energy source. As a result, Mexico has had to import substantial quantities of natural gas, primarily from the US.²

Underlying many of PEMEX's limitations are budget issues. A Mexican Senate report states that hydrocarbon exploration and extraction in Mexico requires US \$60 billion per year. But PEMEX has an annual budget of only US \$20 billion for oil and gas E&P. A substantial part of PEMEX earnings go the Mexican State either as taxes or direct payment, accounting for about 32 percent of total government revenues in 2013. A decrease in these charges to PEMEX would increase the amount available for oil and gas E&P. There was a major tax reform in Mexico at the beginning of 2014 that was intended in part to reduce the burden on PEMEX; however, the fiscal adjustment would bring PEMEX's oil and gas E&P budget up to only US \$30 billion per year, leaving a shortfall of another US \$30 billion.

With all of these circumstances, the Mexican government concluded that it needed to open the Mexican hydrocarbon sector to private industry, based on the premise that private industry would bring technical and operational expertise as well as financial resources to oil and gas E&P. This would allow Mexico to increase federal revenues for the long-term benefit of the

Mexican people, regain Mexico's position as one of the major players in the global petroleum industry, and spark economic development. At the same time, the government wanted to maintain the State's role in stewardship of the hydrocarbons industry, and to conserve for the Nation the ownership of hydrocarbons in the ground. This was the conceptual framework for the Secondary Laws affecting oil and gas E&P.

An Overview of Opportunities for the Private Sector in Oil and Gas E&P under the Hydrocarbons Law

Under the Mexican Hydrocarbons Law, the private sector will be able to pursue oil and gas E&P opportunities in Mexico through contracts with the Mexican government or with Mexico's productive state enterprises such as PEMEX. The permitted forms of compensation to the private sector under those contracts will be: (1) payment of cash, for contract services; (2) payment of cash equal to a percentage of profits upon sale of hydrocarbons, for shared profit contracts; (3) compensation through a right to a percentage of produced hydrocarbons, in shared production contracts; (4) compensation through a transfer of hydrocarbons to the private party, once the hydrocarbons have been removed from the ground, in license contracts; or (5) any combination of the foregoing.

The Hydrocarbons Law further permits a private party with a production sharing contract or a license contract to record for financial and accounting purposes the "expected benefits" of the contract – which in practice means that the private party will be able to record as reserves on its books its

expected share of total reserves in the ground, measured in accordance with the applicable accounting standards – so long as the applicable contract states that hydrocarbons in the ground remain the property of the Nation. This is a significant incentive for international oil companies to take a hard look at the opportunities presented by the new E&P regime.

Under the permitted forms of contract, a private company will be able to participate in oil and gas E&P:

- By participating directly in the bid process for specific oil and gas resources when Mexico, acting through SENER, puts those resources up for auction. As part of the auction tender, SENER will specify the nature of the contract with the Mexican government that will be entered into with the winner of the auction.
- By contracting with PEMEX, in various forms of joint arrangements, to pursue oil and gas E&P opportunities. This includes joint ventures once Assignments to PEMEX, e.g. in Round Zero, have been migrated to contracts. It also includes joint bidding for contracts, and also formation of joint ventures as to contracts where PEMEX has won the contract in an auction process.

There are immediate opportunities for the private sector with PEMEX in connection with the migration of Assignments to contracts. A commentary on this topic will be followed by a discussion of private company participation in auction processes for oil and gas resources not granted to PEMEX by Assignment, the possibility of joint bidding with PEMEX, and finally, the alternative of a joint venture with PEMEX after

it has won an E&P contract in a bid process.

Joint Ventures Following an Assignment to PEMEX.

An “Assignment” is a form of transfer of E&P rights by the Mexican State that is used only for productive state enterprises such as PEMEX, and it is subject to a completely different system of royalties and other payments due to the Mexican government than that for “contracts.”

Following the grant of an Assignment, PEMEX will be permitted—upon the approval of SENER, with technical assistance from the new National Commission of Hydrocarbons (*Comisión Nacional de Hidrocarburos*, or “CNH”)—to “migrate” an Assignment to become a “contract,” with specified technical and financial terms. If PEMEX then wishes to partner with private parties in carrying out the contract, the CNH will conduct a public bidding process to determine who will be selected as the private sector partner to participate in an “alliance” or “association” with PEMEX.

For such bid process, SENER will determine the technical and contractual guidelines and the Ministry of Finance and Public Credit (*Secretaría de Hacienda y Crédito Público* or “Hacienda”), will set the financial terms. Hacienda will also set the variables (i.e. what is being evaluated) for selection of the winner in the bid process, which will be economic in nature, as well as minimum values for the variables to ensure that the revised contract—including the third-party partner—provides revenues to the State not less than what the State would have

received under the original contract following the migration.

PEMEX will have significant influence over the bid process whereby the private sector partner is selected. In establishing the guidelines for the bid process, SENER must seek the “favorable opinion” of PEMEX as to the technical, financial and operational capabilities, as well as the experience, of the companies permitted to participate in the bid process. Also, once the bid process is underway, the CNH must seek the opinion of PEMEX as part of the pre-qualification process, i.e., in pre-qualifying those who seek to participate in the bid. PEMEX’s influence in establishing the bid guidelines, and then in the pre-qualification process, suggest that the companies who want to joint venture with PEMEX should make themselves, and their qualifications, known to PEMEX as early as possible. According to media reports, PEMEX has already established a robust process of pre-selection for possible partners, with special attention to the capabilities required for deep water projects, shale projects, extra-heavy crude, and enhanced recovery.

On August 13, 2014, in conjunction with SENER’s announcement of the results of PEMEX’s Round Zero and the hydrocarbon resources to be included in next year’s Round One tender, PEMEX published a list of the first 10 projects as to which it would seek to enter into joint ventures with private companies. These joint venture projects, which represent a total investment of US \$32.3 billion according to PEMEX’s estimates, include (1) certain mature fields as to which PEMEX seeks to optimize recovery through the use of

cutting edge technology, (2) specified extra-heavy crude fields off the coast of the State of Campeche in which recovery is technically challenging, (3) two large deep water gas fields off the coast of the State of Veracruz, and (4) two recently discovered deep water oil fields off the coast of the State of Tamaulipas.

Participation in a Bid Process for a Contract.

Where oil and gas E&P rights are not granted to PEMEX or another productive state enterprise by means of an Assignment, the granting of such rights will be effected by means of a contract with the Mexican State, acting through the CNH, to be awarded pursuant to an open, competitive bid process. Granting of oil and gas E&P rights through a tender will be particularly important in the case of "prospective oil and gas resources." As noted above, PEMEX received 83 percent of Mexico's 2P reserves (proved and probable) in Round Zero, but only 21 percent of prospective resources. A substantial portion of the prospective resources are non-conventional, e.g. deep water resources and shale beds, where Mexico is most in need of assistance. Accordingly, these resources will be well represented in tenders.

Private companies are permitted to bid in tenders for such E&P contracts. Also permitted to bid are PEMEX and other productive state enterprises. The permitted bidders are allowed to bid individually, in consortium, or in a participatory association, which is a form of contractual partnership.

The bid process for oil and gas E&P opportunities will be carried out by the CNH, and will commence with the publication of a notice in the Daily

Gazette of the Federation (*Diario Oficial de la Federación*). The rules for the bid process and the awarding of a contract will include technical guidelines and financial terms established by SENER and Hacienda, respectively. There must be at least 90 days between the notice of the bid in the Daily Gazette and the presenting of bids.

For the bid rules, SENER will determine among other technical matters, the type of contract to be awarded in the bid process, and the criteria and deadlines for prequalification. Interested parties will be required to comply with the pre-qualification criteria set by SENER as to technical, financial and operational capabilities, as well as experience, before they can participate in the tender. SENER will also establish the mechanisms for clarification of the bid process, for modification of the bid rules where appropriate, and for determining the winner of the tender.

Hacienda will set the basic financial terms of the contract and will also determine the variables for selection of the winner in the bid process, which will be economic in nature so as to maximize revenue to the State. The variables will be associated with the amount of money or the percentage of hydrocarbons to be received by the State, and as deemed appropriate, the amount that the Contractor commits to invest. Hacienda will also set the minimum values that will be acceptable for the bid variables.

Apart from the technical and financial terms, SENER will also have the right to include within the bid terms a participation by the Mexican State, acting through PEMEX, in specified

E&P tenders, i.e. (1) where the resource area to be covered by the E&P contract co-exists, at a different depth, with the area covered by an Assignment; (2) where there are particular opportunities to promote the transfer of knowledge and technology in order to develop the capabilities of PEMEX or another productive state enterprise; or (3) where the contract involves projects determined to be worthy of backing through a specialized finance vehicle of the Mexican State. SENER, with technical assistance from CNH, is also permitted to include in the bid terms a mandatory participation by PEMEX or other productive state enterprise where the resource area to be covered by the E&P contract may include cross-border (e.g. shared by the US and Mexico) hydrocarbon deposits, fields or beds.

The bid process can be carried out by ascending auction, descending auction, or by means of a presentation of a single bid in a sealed envelope, in which case the bids must be presented and opened in the same public session. In whatever form it is carried out, the bid process must be guided by principles of transparency, maximum publicity, equality, competitiveness, and simplicity.

Once a tender is won and the E&P contract is signed, that of course is not the end of the story. The contract will be subject to ongoing administration and supervision as to technical terms by CNH, and to management and auditing of financial terms by Hacienda. Further, the contract is subject to rescission where there is specified non-performance (e.g. failure to make payments or deliver hydrocarbons when due, failure to timely begin work, or continue work

without suspension of activities, subject to specified time periods, and failure to meet minimum work commitments); or where there is specified proscribed behavior (e.g. malicious or negligent contractor actions that result in serious accidents with fatalities, or submission on more than one occasion of false or incomplete contract information to, or concealing such information from, the hydrocarbon regulators, intentionally or without justification).

Joint Bids with PEMEX.

PEMEX and other productive state enterprises will be permitted to enter into “alliances” and “associations” with private companies to participate in open bids for oil and gas E&P opportunities, subject to the law applicable to PEMEX or other productive state enterprises. Such alliances and associations will be subject to the Mexican law generally applicable to alliances and associations. The alliances and associations may be carried out under schemes that allow the highest productivity and profitability, including modalities for the sharing of costs, expenses, investments, risk, as well as profits, production and the other aspects of exploration and production.

Joint Ventures with PEMEX or another Productive State Enterprise as a “Contractor.”

If PEMEX or another productive state enterprise is the winner of a contract for oil and gas E&P and enters into the corresponding contract (becoming a “Contractor”), the Contractor can then enter into a joint venture in the form of an “alliance” or “association” with a private company to exploit the contract.

If by means of the joint venture, there would be a transfer of corporate control or management of the Contractor, or a transfer of operational control of all or part of the area for which E&P rights are granted under the contract, then the prior approval of the CNH will be required in order to enter into the joint venture. In the case of a transfer of operational control, the CNH will evaluate the experience and the technical and financial capabilities of the transferee.

The CNH will review the proposed transfer and provide SENER an opportunity to state its opposition, if any, including the basis for such opposition, within a specified time period. Then, the CNH must provide a response as to the proposed transfer within 10 days after the required SENER response date. Absent a response in that time period, the transfer will be deemed approved.

In the event the proposed joint venture would not cause a transfer of corporate control or management of the Contractor, e.g. in the case of a minority investment without management control, it will be necessary only to give 30 days prior notice to the CNH prior to entering into the transaction.

The New PEMEX under the PEMEX Law and the Other Secondary Laws

Under the PEMEX Law, PEMEX is restructured as a “productive state enterprise.” This is a completely new legal form under Mexican law. As a productive state enterprise, the new PEMEX is designed to be entrepreneurial in nature and driven by business logic, with a focus on profits as a means to increase revenue to the Mexican State as PEMEX’s sole

shareholder. Consistent with the new entrepreneurial model, PEMEX will have substantially greater autonomy than it did previously in terms of management, operations and budget.

Another part of the Secondary Laws provides PEMEX with tools to manage a major existing concern, i.e. PEMEX’s pension obligations. The new tools should permit the newly restructured PEMEX to reduce its existing pension burden and establish a new retirement/pension scheme going forward that will be financially sound and manageable.

The new legal form of the productive state enterprise and the new arrangements on pension obligations, together with Round Zero, are all elements of the overall plan to strengthen PEMEX and increase its competitiveness. Under the new regime, PEMEX should be a strong competitor. But it will also have the capability to be a good partner.

A New Legal Regime.

The new legal regime for PEMEX as a productive state enterprise includes the following elements, designed in each case to allow PEMEX to act like a private company, free of undue government interference, so that PEMEX can compete effectively in the global market:

A Responsible Board. The Board of Directors will be fully responsible for PEMEX’s direction, just as with any other business. The Board is charged with setting the policies, goals and strategic vision for the enterprise. It is also required to prepare and update annually a detailed five-year Business Plan, and establish an annual operational and financial program based on

such plan. The Board will have key committees—i.e. for audit, human relations and compensation, strategy and investments, and procurement—each of which will have specific, detailed responsibilities.

A Diverse Board. The Board will be made up of ten Directors, consisting of (1) the Minister of Energy and the Minister of Finance (the head of Hacienda), (2) three Board members appointed by the President, and (3) five independent Board members nominated by the President and ratified by a two-thirds vote of the Senate. The Board members (other than the Minister of Energy and the Minister of Finance) must be diversified in terms of their training, experience, and skills. The three Board members appointed by the President under category (2) can be removed and replaced by the President at any time. The independent Board members under category (3) will have staggered five-year terms, and can be removed only for cause as specified in the PEMEX Law, with approval from the Senate.

A Qualified Board. The members of the Board, other than the Minister of Energy and the Minister of Finance, must be selected on the basis of their experience, expertise and professional standing, and also (1) have a professional degree in the fields of law, management, economics, engineering, accounting or other subjects related to the hydrocarbon industry, which degree must have been received at least five years earlier than the date of appointment, and (2) have served for at least ten years in activities

that provide the needed experience to perform the duties of a PEMEX director, whether in professional, educational, or research areas.

With a Director General Responsive to the Board. The Director General, who is appointed by the President and has broad responsibilities, can be removed by the President at any time, but can also be removed by the Board of Directors, with the vote of seven directors. The Board will review annually the performance of the Director General, taking into account, among other things, the strategies contained in the Business Plan for PEMEX.

Market-Based Employee Remuneration. The PEMEX Law provides for a market-based system of remuneration. Under that law, the Board of Directors and its Committee on Human Resources and Compensation can set compensation based on the going rate in the national and international labor market for the industry or activity in question, in order to attract and retain suitable personnel to effectively fulfill its purpose. The Board and Committee can also grant incentives or extraordinary payments for the achievement of specified goals, if such arrangements are consistent with the terms prevailing in national and international labor markets.

Flexibility in Procurement. PEMEX will not be subject to the laws on “acquisitions, leases, services, and public works” generally applicable to government agencies and other public entities. Instead, the PEMEX Law includes its own procurement regime. As with the

general law on procurement, the PEMEX Law provides that a public tender is the preferred mechanism for procurement of goods and services. However, the PEMEX Law provides more flexibility to use other procurement mechanisms where a public tender would not provide the best outcome in terms of price, quality, financing, opportunity and other pertinent circumstances in relation to the nature of the contract. The intent is to allow PEMEX to respond to opportunities with the agility that a private company would have.

Budget Autonomy. PEMEX will have autonomy to establish its own budget, subject only to (1) a balance sheet and a cap on personnel costs as the Mexican Congress shall approve based on a proposal from Hacienda, and (2) guidelines as set forth in the PEMEX Law. Those guidelines cover such matters as the elements of the budget and special rules for certain of those elements, timing, procedures for coordination with Hacienda on Congressional approval of the balance sheet and the cap for personnel costs, updates and adjustment to the budget, and reporting.

Issuance of Debt. PEMEX will also have substantial autonomy on the issuance of debt obligations to finance its operations, subject to the following important restrictions: PEMEX debt obligations cannot grant its holders any rights whatsoever in the property, control or capital of PEMEX or its subsidiaries, or over rights to hydrocarbons in the ground. Nor will PEMEX debt obligations constitute obligations guaranteed by the Mexican State.

The Role of the Regulators in E&P Contracts under the Secondary Laws

The key regulators for oil and gas E&P are SENER, Hacienda, and CNH.

SENER.

SENER has the following key responsibilities with respect to E&P contracts:

- Select the areas to be subject to E&P contracts, measured by surface area, depth and the geological formation contained within the surface area at the specified depth (the “Contract Area”) under criteria that SENER shall establish with technical assistance from CNH. (PEMEX, other productive state enterprises, and private companies can suggest Contract Areas to SENER, but that will give the proponent no priority as to that area).
- Issue a five-year program of tenders for Contract Areas, which may be supplemented or modified after publication.
- Specify the contracting model, i.e. the type of contract among the permitted forms described above, for each Contract Area (and hence for each tender) that is best suited to maximize national income, taking into account the views of Hacienda and the CNH.
- Design the technical terms and conditions for the form of contract to be used in E&P contracting.
- Establish technical guidelines for each tender for an E&P contract.
- Plan promotional events and disseminate information nationally and internationally for E&P tenders, for purposes of attracting interest and more bidders to each tender.

- Other matters as contemplated in the E&P contracts themselves and applicable laws.

Hacienda.

The key responsibilities of Hacienda as to E&P contracts are as follows:

- Establish financial terms (payment obligations of Contractors) for tenders and contracts that will allow the Nation to obtain, over time, revenues that contribute to long-term development, in accordance with the Hydrocarbons Revenue Act (*Ley de Ingresos de Hidrocarburos*), another key Secondary Law.
- Determine the variables (i.e. what is being evaluated) for selection of a winner in accordance with the Hydrocarbons Revenue Act.
- Participate in the management and auditing of the fiscal terms of E&P contracts, in accordance with the provisions of the Hydrocarbons Revenue Act. This may be done with the assistance of outside auditors or inspectors.
- Other matters as contemplated in the E&P contracts themselves and applicable laws.

The CNH.

Another of the Secondary Laws, the Law of the Coordinated Regulatory Bodies for Energy (*Ley de los Órganos Reguladores Coordinados en Materia Energética*), creates a new legal, financial and administrative regime for the CNH—currently a part of SENER—which will have an expanded role in the restructured oil and gas industry. Among other things, the Regulatory Bodies Law strengthens the CNH by (1) increasing its budgetary, technical and management autonomy; (2)

making it more difficult for regulated entities to initiate legal challenges against CNH actions; (3) requiring greater openness and transparency with respect to the CNH’s regulatory decision-making; and (4) establishing mechanisms to ensure the CNH’s efforts reflect Mexico’s national energy policies, including establishment of a new Coordinating Board for the Energy Sector in which both CNH and SENER will participate.

With respect to E&P contracts, CNH has a major regulatory and supervisory role, including the following:

- Provide technical assistance to SENER in the selection of the Contract Areas.
- Propose to SENER a five-year program of tenders for Contract Areas.
- Issue the rules to be observed in the procedures for tendering and award of E&P contracts, in accordance with the technical terms and financial guidelines issued by SENER and Hacienda respectively.
- Carry out the tender process for the award of E&P contracts. CNH will be responsible for developing, managing and publishing technical information on the Contract Areas subject to tender.
- Sign E&P contracts on behalf of the Mexican State.
- Administer and supervise, as to technical matters, the E&P contracts. This may be done with the assistance of third party auditors or inspectors, by contracting for such third party services.

- Approve, as appropriate, the modification, cancellation or termination of oil and gas E&P contracts, in accordance with the terms of the applicable contract and with the technical terms and financial guidelines issued by SENER and Hacienda respectively.
- Approve plans for exploration or for development of production that maximize the productivity of the Contract Area over time, and any amendments thereto; and monitor compliance with such plans, in accordance with the regulations that CNH issues on these matters.
- Grant drilling authorizations to the holders of Assignments or E&P contracts that seek to drill exploratory wells, deep water and ultra-deep water wells, or wells used for design modeling purposes (“Drilling Authorizations”).
- Approve, as appropriate, the annual investment and operations programs for E&P contracts.
- Approve the transfer of corporate control or operations for a Contractor, in accordance with the requirements of the Hydrocarbons Law and the regulations that CNH issues on these matters.
- Other matters as contemplated in the E&P contracts themselves and applicable laws.

The National Priorities that will be Advanced under the Secondary Laws and How those Priorities Affect the Regulatory Structure for Oil and Gas E&P

Transparency and Accountability. Two key principles of the Secondary Laws are transparency and accountability. These principles are included in the Secondary Laws in the following ways:

Institutional Architecture. One key element of transparency and accountability is the institutional architecture set forth in the Hydrocarbons Law for open, competitive bidding processes, i.e., the use of a tender process for (1) selection of PEMEX partners after Assignments are migrated to contracts and (2) the granting of oil and gas E&P rights over Contract Areas that have not been assigned to PEMEX.

One caveat to the benefits of such open, competitive bidding processes relates to the influence of PEMEX on the selection process for PEMEX partners following the migration of an Assignment to a contract. As discussed above, PEMEX will be able to shape the tender process to favor its preferred partners, i.e., in the specifications for potential partners, and in the pre-qualification process. It is also noteworthy that for a general tender of oil and gas E&P rights, the contract ultimately awarded will be subject to the prior approval of the Federal Economic Competition Commission (*Comisión Federal de Competencia Económica*), Mexico's antitrust regulator, which will focus exclusively on the pre-qualification criteria and the mechanism for the granting of the award. That prior approval requirement is not applicable for tenders to select a PEMEX partner.

Transparency as to Key Information. Both SENER and CNH have specific duties as to dissemination of information regarding Assignments and E&P contracts, including the following:

SENER:

- The number of Assignments that have been granted and are in force.
- The areas that will be subject to tender for contracts, including SENER's five-year program for tenders.

CNH:

- The number of existing contracts, as well as their terms and conditions. This is a key point because the terms and conditions would include pricing.
- The results and statistics for the bid processes for the granting of contracts.
- The rules for the bid processes that have been used to award contracts.
- The number of Drilling Authorizations that have been granted and are in force, as well as their terms and conditions.
- Information related to the technical administration and monitoring of the contracts.
- The volume of hydrocarbons produced pursuant to each E&P contract.

Codes of Conduct. SENER, CNH and the National Agency for Industrial Safety and Protection of the Environment in the Hydrocarbon Sector, discussed below, are all subject to strict Codes of Conduct. The Codes will include (1) guidelines on meetings between the regulator and the regulated parties; (2) restrictions on attendance, by any public servant working at a regulatory body, at academic events, forums or other

public events related to the relevant area of regulation; and (3) restrictions on taking anything of value.

Anti-Corruption Prohibitions. The Hydrocarbons Law states that all matters and procedures related to Assignments and E&P contracts are subject to the general anti-corruption law. In addition, there are specific prohibitions that apply to individual and companies, domestic to Mexico or foreign, involved in specific acts of wrongdoing with respect to Assignments and E&P contracts, where the competent authorities will determine the sanction, based on applicable anti-corruption norms. In addition, such actions can serve as the basis for cancellation of the Assignment or contract in question.

Industrial Safety and Protection of the Environment in the Hydrocarbon Sector.

The National Agency for Industrial Safety and Protection of the Environment in the Hydrocarbon Sector (*Agencia Nacional de Seguridad Industrial y Protección al Medio Ambiente del Sector Hidrocarburos*, or “Agency”) will have considerable power in the scope of authority granted to it. It is a specialized institution with management autonomy, responsible for regulating and supervising industrial and operational safety, as well as protection of the environment, in the activities of the production chain for hydrocarbons. It was created according to international best practices to the effect that the same entity should not administer the country’s natural resources and also have responsibility for regulating and supervising industrial safety and environmental protection. The rules and regulations that the Agency will

promulgate and then enforce could potentially have a significant impact on operations under an E&P contract. The Contractor under such contract will have to pay close attention to the Agency and the actions it takes to carry out its mandate.

Access to Land for E&P, While Protecting Landowners.

The Hydrocarbons Law provides a mechanism to ensure that the holder of an Assignment or an E&P contract can obtain the land rights they need for the exploration and production contemplated by the Assignment or contract.

The process for obtaining land rights is intended to be balanced and fair to both sides. The Hydrocarbons Law establishes a requirement that land rights for oil and gas exploration and production be negotiated, within a specified framework. Only in the case of a deadlock will the holder of the Assignment or E&P contract have a right to (1) seek a legal order granting an energy servitude (right of access and use) to the land in question, or (2) seek a mediation according to specified terms, and then, if that is unsuccessful, obtain a government order granting an energy servitude to the land in question. The energy servitude, if granted, will be subject to payment of consideration determined by the court, or in the case of a failed mediation, according to specified procedures that are part of the mediation.

Part of the required consideration for use of land rights if there is production of hydrocarbons is a negotiated royalty, which will be between 0.5 percent and 2 percent of the revenues earned by the holder of an Assignment or E&P contract,

after deduction of certain payment obligations to a development fund as required by law, except in the case of natural gas not associated with petroleum (primarily shale gas), in which case the range will be between 0.5 percent and 3 percent.

National Content.

One objective of the Secondary Laws is to benefit providers of goods and services in Mexico, i.e. to leverage the energy natural resources of the country in order to benefit Mexican businesses generally. To this end, the Hydrocarbons Law includes a national content requirement that will apply to E&P, as follows: The average minimum percentage of national content in hydrocarbons E&P will increase gradually from 25 percent in 2015 to at least 35 percent in 2025, and must be revised every five years. This goal will exclude activities in deep and ultra-deep waters, for which the Ministry of the Economy with the opinion of SENER will set the values for 2015 and 2025, based on a study that the Ministry of the Economy will carry out as to the observed national content in connection with such activities in the first half of 2014.

These requirements will present a challenge to private companies that want to participate in Mexican E&P, on several grounds. First, it is not at all clear how the general guidelines will apply to a specific company that wants to joint venture or bid on a specific Contract Area. Second, once the requirements are understood, it will be necessary to find qualified contractors and suppliers, and become comfortable with their work. That can be a time-consuming process, requiring much vetting of potential contractors or suppliers.

Conclusion

There are considerable new opportunities in Mexican oil and gas E&P that are now open to the private sector under Mexico's energy reform. Those opportunities include contract arrangements with Mexico's productive state enterprises such as PEMEX, and also E&P contracts between the Mexican State, acting through the CNH, and the winner of the bid process for E&P rights put up for tender.

Pillsbury will continue to monitor the implementation of Mexico's energy reform with respect to hydrocarbon exploration and production. That implementation will require the restructuring of PEMEX and the CNH, resolution of ambiguities in the Secondary Laws, and development of the actual policies, procedures and documentation within SENER, Hacienda and CNH that will be used to carry out the mandates of the Secondary Laws. The opportunities for the private sector under the energy reform are significant. But to take advantage of those opportunities, it will be necessary to:

- Understand the Secondary Laws and how they are interpreted by the regulatory authorities;

- Learn about the new PEMEX, reconstituted as a productive state enterprise, and how PEMEX will operate in the new energy reform environment; and, finally,
- Master the policies, procedures and documentation whereby the Secondary Laws will be carried into effect.

If you have any questions about any aspect of the Mexican energy reform, please contact the authors below or the Pillsbury attorney with whom you regularly work.

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About Pillsbury Winthrop Shaw Pittman LLP

Pillsbury is a full-service law firm with an industry focus on energy & natural resources, financial services including financial institutions, real

estate & construction, and technology. Based in the world's major financial, technology and energy centers, Pillsbury counsels clients on global business, regulatory and litigation matters. We work in multidisciplinary teams that allow us to understand our clients' objectives, anticipate trends, and bring a 360-degree perspective to complex business and legal issues—helping clients to take greater advantage of new opportunities, meet and exceed their objectives, and better mitigate risk. This collaborative work style helps produce the results our clients seek.

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Endnotes

- ¹ The Hydrocarbons Law also regulates: (1) the treatment, refining, sale, marketing, transportation and storage of petroleum; (2) the processing, compression, liquefaction, decompression and regasification, as well as the transportation, warehousing, distribution, marketing and sale to the public, of natural gas; (3) the transportation, storage, distribution, marketing and sale to the public of petroleum products derived from oil and gas, such as gasoline, diesel, kerosene, fuel oil and liquefied petroleum gas; and (4) the transport by pipeline and storage linked to pipelines of petrochemicals. This Client Advisory focuses only on oil and gas E&P.
- ² Further, PEMEX and CFE, Mexico's state-owned utility, have undertaken major programs for third-party construction of gas pipelines to provide more natural gas for electricity generation. The objective is to reduce the price of electricity. Mexico's growing pipeline network will only increase the country's demand for gas.

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