

January 13, 2014

México Projects Part II: Off to the Races!

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On December 12, 2013, Mexico's Federal Congress passed historic Constitutional reforms opening both the oil and gas and electricity sectors to private investment. Within 96 hours, the required 16 state legislatures affirmatively supported the amendment. The decree was published December 20, 2013 and became effective on December 21, 2013. As a follow-on to our client alert "México Projects: Get Ready, Get Set . . .," this alert summarizes the key changes in the decree.

The energy reform is an historic accomplishment of the Mexican government. Following a 75-year monopoly by Petróleos Mexicanos (PEMEX) in the oil and gas sector, and the effective monopoly of Comisión Federal de Electricidad (CFE) in the electricity sector, the reforms terminate such constitutionally mandated arrangements in favor of open, transparent and competitive (and regulated) markets.

Though the greater step in the process has been accomplished, more is to come by way of secondary legislation and regulations, as contemplated by the [energy reform bill].

Comprehensive Constitutional Reform

The oil and gas sector reforms are significantly enhanced from the original August 12, 2013 proposal of President Enrique Peña Nieto, which was limited to paving the way for profit-sharing contracts as the vehicle for channeling private investment into the oil and gas sector. The [energy reform bill] draws a clear picture of a revamped energy sector in Mexico. The enhancements to the President's original proposal are not fully reflective of the July 31, 2013 proposal of Partido Acción Nacional (PAN), the main opposition party, but do prove to be a much more favorable consolidation of the President's and the PAN's proposals than initially expected. Clearly, political capital was expended by the two main political parties to draft a compromise that is overall a significant improvement to the two separate versions originally proposed by the President and the PAN.

Substantively, oil and gas (even though the new, revised text in the Constitution upholds and reinforces what has long been close to the heart of Mexico—sovereignty, ownership over hydrocarbon resources), and electricity, will become fully and vertically privatized industries. In addition to the revisions to the Constitution, the transitional articles of the decree set forth a detailed course of action and timeline to ensure proper implementation of the revised Constitutional provisions.

Principal Reforms in Oil & Gas

Ownership and Booking of Reserves. Under the Constitution, private enterprise will not have direct ownership of subsoil hydrocarbon resources. However, pursuant to Transitional Article Five, private enterprises may record and report oil and gas reserves for accounting and financial purposes with respect to the assignation or associated contract evidencing the same, as long as such assignation or contract sets forth that title to all subsoil hydrocarbon resources resides with the nation. The ability to recognize the reserves in financial statements alone is significant and addresses one of the major concerns international oil companies and other constituencies had observed with respect to the President's proposal.

Contracts. Transitional Article Four contemplates various forms of contract for exploration and production activities, while Transitional Article Five sets forth the forms of payment for such contractual forms. The list of contracts is not exhaustive and leaves open the door for additional types of contracting mechanisms to be determined in secondary legislation. The forms expressly contemplated are: (i) service contracts, (ii) production sharing contracts, (iii) profit sharing contracts and (iv) licenses. Secondary legislation will determine the appropriate type of contract for specific activities and/or circumstances on the basis of maximizing revenues to attain the greatest long-term development benefits; however, the mere existence of these contractual options (and others to come) establishes a clear framework within which private enterprise will become actively-involved participants in the oil and gas sector in Mexico. Importantly, the Constitution now provides that the exploration and production of oil and gas is of social interest and a matter of public order. Given this status, such activities will have priority over other activities conducted above or under ground, such as mining.

Governmental Authorities and Regulators. The oil and gas industry in Mexico will fall within the purview of the Ministry of the Economy (Secretaría de Economía), the National Hydrocarbon Commission (Comisión Nacional de Hidrocarburos), the Energy Regulatory Commission (Comisión Reguladora de Energía), the Ministry of Finance (Secretaría de Hacienda y Crédito Público) and the newly-created National Natural Gas Control Center (Centro Nacional de Control del Gas Natural).

The National Hydrocarbon Commission (CNH) will continue to provide technical advice to the other authorities, inventory hydrocarbon assets and, most importantly, administer the assignation and contracting of exploration and production activities and regulation of the exploration and production industry, among others.

The Energy Regulatory Commission (CRE) will, in addition to functions currently performed by CRE, include the regulation and granting of permits relating to storage, transportation and pipeline distribution of petroleum-based products, and the regulation of third-party open-access rights to pipeline and storage facilities and first-hand sales.

Ownership and administration of the national pipeline system will be vested in the newly created National Natural Gas Control Center (CENAGAS) pursuant to Transitional Article Sixteen. Regulations governing the creation, existence and functions of CENAGAS are required to be issued no later than 12 months after publication of the Constitutional reforms. Pipeline assets and storage facilities currently owned and operated by PEMEX will be transferred CENAGAS.

Pemex. The new constitutional provisions envision a privatized industry in which PEMEX becomes an "empresa productiva" (a productive enterprise) of the state, standing side-by-side with private enterprise. Additionally, PEMEX is authorized to co-invest with private investors in the extraction and production of oil and gas. In a first phase of implementation of the changes envisaged by the reforms, PEMEX will be entitled to the direct assignation of oil and gas

resources, whether presently in production or already identified (though not in production). The Transitional Articles describe the process to be followed by PEMEX for the identification and assignation of such assets.

Mexico Oil Fund for Stabilization and Development. A public trust will be created under the administration of the Central Bank of Mexico (Banco de México) for the purposes of receiving, administering and applying revenues from oil and gas assignations and contracts.

Electricity

The Constitutional reforms relating to electricity change the landscape of the sector, by expanding upon prior attempts to privatize the electricity sector and opening the sector to private investment. Unrestricted private investment in the generation of electricity will now be allowed, while the CRE will be charged with setting wheeling tariffs and interconnection fees. CFE will also become an “empresa productiva” (a productive enterprise) of the state, standing side-by-side with private enterprise, and continuing to operate as a generator.

The national electric grid will be owned, operated and maintained by the newly created state-owned Centro Nacional de Control de Energía (National Electricity Control Center). The grid operator will receive ownership of all transmission assets and related facilities from CFE, with regulations governing the creation, existence and functions of CENACE to be issued after publication of the Constitutional reforms. CENACE will also be charged with the management of the wholesale market and open access to transmission facilities in Mexico. The Constitution also provides, similar to oil and gas related activities, that transmission and distribution of electricity is of social interest and a matter of public order and, therefore, such activities take priority over other activities conducted above or under ground.

Timelines for Implementation

The Transitional Articles of the Constitutional reforms set forth the timeline for the implementation of all actions required to effectuate the provisions of such reforms. The timeline is more aggressive than had been suggested in the PAN proposal (originally, 365 days from publication to implement the changes).

Under the Transitional Articles, the following is required to occur:

1. On or prior to March 21, 2014, Pemex will provide the Ministry of Energy with a list of oil fields and assets Pemex would continue to exploit following the opening of the sector;
2. On or prior to April 19, 2014, legislation and regulations (or changes to existing legislation and regulations) will be promulgated:
 - a. in order to more fully effectuate the provisions of the Constitutional reforms, including fleshing out the types of contracts and the requirements thereof;
 - b. relating to the regulation of “empresas productivas del Estado” (State productive enterprises);
 - c. in respect of the enhanced functions and power of certain agencies and governmental authorities, including the Ministry of Energy, the Ministry of Finance, the National Hydrocarbon Commission and the Energy Regulatory Commission;
 - d. to regulate the types of contracts to be employed in connection with the transmission and distribution of electricity;

- e. (i) to ensure that the National Hydrocarbon Commission and the Energy Regulatory Commission become coordinated regulatory agencies and (ii) with respect to the offices of the commissioners in such agencies, and the attributes thereof;
 - f. with respect to corrupt practices;
 - g. with respect to the discovery, exploration and exploitation of geothermal resources; and
 - h. to create the National Agency for Industrial Safety and Environmental Protection as it relates to the Petroleum Industry;
3. During 2014, the Mexico Oil Fund for Stabilization and Development shall be created;
 4. During 2015, the Mexico Oil Fund for Stabilization and Development shall commence operations;
 5. On or prior to December 21, 2014:
 - a. Congress shall enact legislative and regulatory changes establishing the guidelines for environmental protection, as they relate to the oil and gas and electricity sectors; and
 - b. The President shall incorporate a transition strategy into the National Program for the Sustainable Exploitation of Energy (Programa Nacional para el Aprovechamiento Sustentable de la Energía);
 6. Within 12 months of the Constitutional Article 27 Regulatory Law coming into force, the decree creating CENAGAS shall be promulgated;
 7. Within 12 months of the regulatory laws in respect of the electricity sector coming into force, the decree creating CENACE shall be promulgated; and
 8. On or prior to December 21, 2015, both CFE and PEMEX will fully transition into “empresas productivas del Estado”.

Final Comments

The Constitutional reforms approved by Mexico are historic. The deep-rooted conviction that ownership of petroleum is fundamental to Mexico’s sovereignty has given way to a new regime which preserves title to subsoil hydrocarbons, but allows private investment in the much needed infrastructure and technology to more efficiently, effectively, competitively and transparently develop the oil and gas sector in Mexico. Likewise, the electricity sector, which had slowly been allowed to allow for private investment, will be restructured to reflect other competitive electricity markets, such as in Chile.

Though opportunities will arise, there is still much work to be done. The challenges that lie ahead will include detailing the terms and conditions for the contractual framework and options presented by the reforms through a cohesive set of legislation and regulations that is all-encompassing and consistent with the reforms. It is difficult to anticipate the full impact of the reforms with secondary legislation and regulations still pending, but the reforms do provide sufficient and substantive guidelines indicating the future of these sectors. We are off to the races!

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