SEPTEMBER 2014

COMMENTARY

Mexico's New Regulatory Framework for Oil and Gas

The following is the first chapter in a four-part Commentary discussing the groundbreaking reforms to Mexico's oil and gas sector. The Commentary *chapters and their publication dates are as follows:*

Part I - Mexico's New Regulatory Framework for Oil and Gas
Part II - Private Investment in Mexican Natural Resources—September 25, 2014
Part III - Transportation, Refining, Environmental, and Tax—October 2, 2014
Part IV - What's Next for Mexico?—October 9, 2014

It is a time of change and a time of opportunity in Mexico. Mexico has implemented a series of structural changes that are designed to promote the country's economic growth and stability, through a series of legal reforms that culminate in the recently enacted secondary legislation to the Mexican Energy Reform law. Mexico's Congress had previously approved President Enrique Peña Nieto's proposed labor, antitrust, tax, education, electoral process, and telecommunications reforms, and now it has approved sweeping reforms to Mexico's oil and gas and electricity sectors.

On April 30, 2014, President Peña Nieto submitted to the Mexican Congress a package of legislation designed to implement the historic constitutional energy reform that he had signed the previous December. Styled the "secondary laws," this new legislation consists of nine new laws and amendments to 12 existing laws. After review and discussion, Congress approved the secondary laws, which were then published into law on August 11, 2014, with most entering into force on August 12.

The "secondary laws" consist of the following:

1. Hydrocarbons
    a. Law of Hydrocarbons* (*laws marked with an asterisk are new*)
    b. Foreign Investment Law
    c. Mining Law
    d. Public Private Associations Law

2. Electricity
    a. Law of the Electricity Industry

3. Geothermal
    a. Law of the Geothermal Industry*
    b. Law of National Waters

4. National Agency for Industrial Safety and Protection of the Environment in the Hydrocarbons Sector
    a. Law of the National Agency for Industrial Safety and Protection of the Environment in the Hydrocarbons Sector*

5. State Productive Corporations
    a. Law of *Petroleos Mexicanos* ("Pemex")*
    b. Law of the Federal Electricity Commission ("CFE")*
    c. Federal Law for State-Owned Agencies
    d. Law of Acquisitions, Leases, and Services of the Public Sector
    e. Law of Public Works and Related Services

6. Regulatory Agencies and the Organic Law of the Federal Public Administration
    a. Law of the Coordinated Regulatory Agencies for the Energy Industry
    b. Organic Law for the Federal Public Administration

7. Tax
    a. Income Law on Hydrocarbons*
    b. Federal Rights Law
    c. Tax Coordination Law

8. Law of the Mexican Oil Fund for Stabilization and Development
    a. Law of the Mexican Oil Fund for Stabilization and Development*

9. Budget
    a. Federal Budget and Fiscal Responsibility Law
    b. General Law for Public Debt.

The new legal framework for oil and gas in Mexico represents two major changes for the industry: (i) a complete transformation of Pemex, which prior to the reforms had enjoyed monopoly status in the sector, and which will now have more of a commercial profile, and (ii) the opening of the upstream, midstream, and downstream sectors to private participation.

Transformation of Pemex

Since 1938, the exploration, extraction, and production of oil and gas in Mexico, as well as the transportation, storage, and refining of hydrocarbons and petrochemicals, have been an exclusive monopoly of the Mexican government, acting through Pemex. In the 1990s, private entities were allowed to participate in gas transportation, storage, and distribution, but most private projects were dedicated to serve either Pemex or the CFE.

The new energy reform legislation creates the concept of Productive State Corporations ("PSCs"), which are entities owned by the Mexican federal government that are business-oriented and focused on maximizing revenue for their owner. The new legislation has conferred PSC status on Pemex and the CFE. In a significant departure from the past, Pemex and the CFE will now have an entrepreneurial nature, will be governed by commercial laws, and will be subject to corporate governance similar to a private entity. They will also have disclosure obligations that are similar to those that apply to publicly traded companies, even though they will not be listed on any stock exchange. In addition, Pemex and the CFE will now compete in the new Mexican energy sector with third parties.

Pemex will now be managed by a board of directors composed of five government-appointed members—among whom will be the heads of the *Secretaría de Energía* (the Mexican Secretary of Energy) and the *Secretaría de Hacienda y Crédito Público* (the Mexican federal tax authority)—and five independent members. Similarly, Pemex will be restructured as a holding company with two subsidiaries: a primary-production subsidiary (responsible for exploration, production, and processing activities) and an industrial-transformation subsidiary (responsible for refining and petrochemicals). This is a change from the four subsidiaries that Pemex currently owns. Sales of oil and gas will continue to be through private companies, which may be incorporated outside of Mexico.

The energy reform package establishes special treatment for PSCs for budgeting, procurement and financing. PSCs are now subject to budgetary rules that are autonomous from the Mexican federal government and distinct from Mexican government agencies, enabling them to invest a larger percentage of their resources in exploring for and producing oil, gas, and other resources from new fields, as well as increasing the productivity of existing fields, with both short-term and long-term return strategies. Further, any direct or contingent debt incurred by a PSC will no longer be considered public debt of the Mexican government.

In practical terms, this new budgetary framework means that Pemex will be responsible for managing its own debt obligations and entering into financing arrangements without direct intervention in day-to-day operations from the Mexican Ministry of Finance and Public Credit, as was the case in the past. Pemex's only obligation will be to send a global funding proposal to the Ministry of Finance and Public Credit once per calendar year, for incorporation into the global government debt ceiling that is approved by the Mexican Congress.

A New Regulatory Landscape

The new legislation confirms that all hydrocarbons found beneath the surface will continue to be owned by the Mexican state, and it provides that those hydrocarbons will be managed by the National Hydrocarbons Commission ("CNH"). The CNH will have the authority to grant licenses (*asignaciones*) to PSCs, including (but not limited to) Pemex, for the development (specifically, exploration and production) of oil and gas resources. The CNH may also authorize PSCs and Pemex to enter into service contracts, profit-sharing contracts, or production-sharing contracts with private entities. In addition, all reserves that had previously been owned by Pemex have now been transferred to the CNH. The CNH will also manage the development of geophysical and geological information in Mexico and will grant operating licenses.

The energy reform package also establishes the Law of Coordinated Regulatory Energy Entities, as well as amendments to the Law of the Federal Public Administration. The Law of the Coordinated Regulatory Energy Entities will regulate the organic elements of the CNH and the *Comisión Reguladora de Energìa* ("CRE," the National Energy Regulatory Commission of Mexico), while the Hydrocarbons Law, the Electric Industry Law, and the Geothermal Energy Law will establish the obligations, powers, and attributes of the CNH and the CRE.

The Coordinated Regulatory Energy Entities will have technical, operational, and management autonomy, as well as financial autonomy derived from the collection of government fees and charges. They will have a governing body made up of seven commissioners assigned by the Mexican Senate, each of whom will be selected from candidates proposed by the president.

Round Zero

Although the CNH will be responsible for administering Mexico's oil and gas resources, the energy reform legislation granted to Pemex a preferential right to request licenses to develop onshore and offshore blocks, provided that Pemex could show technical and financial feasibility to explore for and produce hydrocarbons from those blocks. Designated "Round Zero," this process concluded on August 13, 2014, when the CNH announced which blocks had been assigned to Pemex. One sign of the Mexican government's commitment to a quick opening of the oil and gas sector is that the announcement was made in mid-August, even though the official deadline for the CNH's determination was not until September 17, 2014.

To maximize efficiency and the likelihood of success, Pemex has several options to develop the blocks that it has been assigned: (i) independently, and without the involvement of any additional entity other than subcontractors; (ii) pursuant to a production-sharing contract or a profit-sharing contract with a third party; or (iii) pursuant to a partnership or joint venture.

Now that Round Zero has concluded, Pemex has announced that initially, it is considering the formation of 10 partnerships for the development of blocks or groups of blocks that, due to their technical complexity and intense capital requirements, necessitate the participation of private operators. These blocks have been grouped into the following categories: (i) mature onshore and offshore blocks, (ii) offshore heavy oil blocks, (iii) giant deepwater reserves, and (iv) recent discoveries. Under the Hydrocarbons Law, Pemex's partners will be selected through a public bidding process managed by the CNH (pursuant to technical guidelines established by the Ministry of Energy), in what has become known as "Round 0.5."

In those cases where Pemex wishes to partner with third parties, the license that Pemex received from the CNH will be converted into a contract between Pemex (or a special purpose company established by Pemex), the third party partner, and the CNH. If the CNH and the Ministry of Energy approve the conversion, the Mexican Ministry for Finance and Public Credit will establish the fiscal terms (including royalties) that will apply to the contract. Although Pemex will have some input into the technical, financial, and experience requirements that will apply to its partner, the public bidding process itself will be conducted by the CNH. The procedures that will apply to that bid process are the same as those that will apply to contracts that do not involve Pemex, as discussed in more detail in a future installment of this *Commentary*.

Lawyer Contacts

For additional information about the reforms in Mexico, or for previous installments of this *Commentary*, please contact one of the following Jones Day attorneys. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Alberto de la Parra
Mexico City
+52.55.3000.4087
adelaparra@jonesday.com

Scott Schwind
Houston
+1.832.239.3710
sschwind@jonesday.com

Mauricio Llamas
Mexico City
+52.55.3000.4082
mllamas@jonesday.com

José Estandia
Mexico City
+52.55.3000.4081
jestandia@jonesday.com