THE OPENING OF MEXICO’S ENERGY SECTOR

Insight into Mexico’s Energy Reform

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Overview of Presentation

INTRODUCTION
I. UPSTREAM
II. MIDSTREAM AND DOWNSTREAM
III. PEMEX CORPORATE GOVERNANCE
IV. NEXT STEPS
The Opening of Mexico’s Energy Sector

INTRODUCTION

• On December 21, 2013, a sweeping and historic energy reform bill became law in Mexico.
  – Reform passed with support from more than 2/3 of both houses of Congress and a majority of Mexican state legislatures.

• The Reform represents the most significant overhaul of the country’s energy industry since 1938.

• The Reform is widely expected to result in a significant influx of private capital, technology and technical expertise into Mexico’s upstream, midstream and downstream oil and gas industries.
The Opening of Mexico’s Energy Sector

I. UPSTREAM

A. Amendment to Article 27

• Prior to the Reform, Mexico had one of the most restrictive legal frameworks for energy development and production in the world.

• The Reform’s amendment to Article 27 of the Constitution repeals the restrictions on private sector participation in the upstream oil and gas industry and establishes that the State may grant contract rights to the country’s oil and gas resources either to PEMEX or to private parties.
B. New Contractual Framework

- The Reform expressly lists the following contracts as available for use by the State:
  - Licenses;
  - Production-sharing contracts;
  - Profit-sharing contracts; and
  - Pure service contracts.

- This is a nonexclusive list.
  - “Other” instruments are also permitted under the Reform.

B. New Contractual Framework (continued)

- In choosing a contractual model for a particular area or project, the State’s guiding principle shall be “maximizing revenue.”

- Congress is required to pass secondary (implementing) legislation detailing this contractual framework within 120 calendar days of the enactment of the Reform.
C. Administration of Upstream Exploration and Production

• New multi-agency regulatory framework.
  — The Ministry of Energy is charged with:
    • Developing energy policy;
    • Selecting the geographic areas for upstream contracts;
    • Determining the areas that PEMEX will retain under "Round Zero"; and
    • Designing upstream contracts and establishing the technical and financial requirements for bidding.
  — The Ministry of Finance is responsible for developing the fiscal terms and economic conditions applicable to upstream contracts.

C. Administration of Upstream Exploration and Production (continued)

• National Hydrocarbons Commission (Comisión Nacional de Hidrocarburos) is charged with:
  — Conducting bidding processes for E&P contracts;
  — Collecting geologic and operational information;
  — Evaluating bids and awarding contracts;
  — Providing technical assistance to the Ministry of Energy on various matters; and
  — Monitoring exploration and production plans to ensure compliance with the contracts and maximize productivity.
C. Administration of Upstream Exploration and Production (continued)

- New independent agency, the **National Agency of Industrial Security and Environmental Protection of the Hydrocarbon Sector** to regulate and oversee HSE.

- The Reform also creates the **Mexican Oil Fund**, which is entrusted with receiving, administering and distributing all hydrocarbon revenues (excluding the taxes paid by oil companies).
  - Structured as a public trust with Mexico’s central bank as trustee.
  - Technical committee:
    - 3 representatives from the government; and
    - 2 independent members (appointed by the President and approved by two-thirds of the Senate).

- Caps transfers to the Treasury at current levels relative to GDP and allocates excess funds to specific investment programs.

- To become operational in 2015.
D. “Round Zero”

• PEMEX will request to retain “assignations” in areas that it already has under production or that it is actively exploring subject to PEMEX’s technical, financial and operational capabilities.

• After this initial process (Round Zero), PEMEX is to compete on an equal footing with other operators in bidding for additional contract areas.

(continued)

• How Round Zero will work:
  – PEMEX must submit applications to the Ministry of Energy requesting the “assignation” of areas to retain.
  – Such applications are to be filed by March 21, 2014.
  – In its application, PEMEX must:
    • specify the area, depth and term of the requested allocation; and
    • demonstrate that it possesses the necessary technical, financial and administrative capabilities to carry out exploration and production activities in that area in an efficient and competitive manner.
D. “Round Zero” (continued)

- The Ministry of Energy, with technical assistance from the National Hydrocarbons Commission, decides whether to grant the requested assignations as well as the assignation’s area, depth and term.

- Assuming PEMEX is qualified to operate in a particular field or area, the Ministry of Energy is to grant PEMEX the following:
  - PEMEX will retain assignation of areas that were producing as of December 21, 2013 (needs to submit development plan).
  - PEMEX may retain for 3 years (with a possible 2-year extension, subject to a pre-established exploration plan) assignations in areas where PEMEX has made commercial discoveries or exploratory investments as of December 21, 2013.

- The Ministry of Energy must approve or reject the application within 180 days of the application’s filing (thus, at the latest by September 17, 2014).

- PEMEX may not assign assignations without the prior consent of the Secretary of Energy.

- PEMEX may enter into joint ventures or other arrangements with private companies to develop the assignation areas under a legal framework to be established in the secondary (implementing) legislation (to be enacted by April 24, 2014).
D. “Round Zero” (continued)

- PEMEX may also request the “migration” of an assignation into any type of contract. Assignations converted into contracts would be subject to the same rules and regulations as other upstream contracts granted to private companies.

- After such conversion, if PEMEX wishes to enter into contracts with private parties to develop the converted areas:
  - the National Hydrocarbons Commission would conduct a bidding process (*licitación*) to select such private party;
  - the Ministry of Energy will establish the technical and contractual guidelines; and
  - the Ministry of Finance will establish the fiscal terms.
E. Booking Reserves

Prior to the Reform, under the misconception that booking of reserves meant claiming legal ownership of reserves in place, booking of reserves was banned by Article 60:

– Article 60(II) of the PEMEX Law established that “no right shall be granted to the oil reserves, and thus the service providers or contractors shall not be able to register them as their own assets, and the Nation shall always register them as part of its patrimony.”

E. Booking Reserves (continued)

The Reform provides that PEMEX and private companies will be able to “report for accounting and financial purposes, the corresponding assignment or contract and their expected benefits” with the understanding that while the hydrocarbons remain in the subsoil, ownership thereof resides exclusively with the State.

For companies subject to SEC guidelines, what is most important is the absence of a restriction to the booking of reserves for disclosure and reporting purposes.
II. MIDSTREAM AND DOWNSTREAM

Prior to the reform, Article 28 of the Constitution provided that hydrocarbons and basic petrochemicals were “strategic areas” reserved exclusively to the state.

The Constitution, together with two federal statutes (the PEMEX Law and the Regulatory Law of Article 27 of the Constitution) granted PEMEX a monopoly over every step of the petroleum value chain, including exploration, production, distribution, storage, refining and marketing of petroleum and petroleum products.

These limitations have been removed.
• The Reform ends PEMEX’s monopoly and opens the midstream and downstream sectors to private investment and competition.

• Under the new framework, the Energy Regulatory Commission will be in charge of granting permits to private companies for the storage, transportation and distribution of hydrocarbons and regulating firsthand sales.

• The Ministry of Energy will be in charge of granting permits to private companies for refining and natural gas processing facilities.

• The Reform provides that, within 12 months of the enactment a new Regulatory Law of Article 27, the executive branch must establish the National Center of Natural Gas Control to operate the national pipeline network.
The Opening of Mexico’s Energy Sector

III. PEMEX CORPORATE GOVERNANCE

• The Reform also seeks to convert PEMEX (and CFE) into a “productive” state-owned enterprise that would compete in the marketplace.

  – PEMEX’s main objective going forward will be “creating economic value and increasing the Nation’s revenue, following the principles of equity, and social and environmental responsibility.”

  – PEMEX will have autonomy concerning the approval of its budgets.

  – PEMEX is to adopt industry best practices (organization, administration and corporate structures).
PEMEX Corporate Governance (continued)

- PEMEX will also have a new board of directors composed of five independent members and five members of the federal government, with the Secretary of Energy presiding over the board.
  - Among other things, this change removes the right of the PEMEX union to representation on the PEMEX board.
- PEMEX will have special procurement rules in order to compete efficiently in the industry.
  - The Reform requires that PEMEX become a productive state-owned enterprise within two years of the Reform’s enactment.
  - Secondary (implementing) legislation will detail how the transition is to take place.
Timeline for Implementation

Reform formally enacted into law
December 21, 2013

Round Zero: Request of Areas by PEMEX
March 21, 2014

Passage of secondary (implementing) legislation
April 20, 2014

Round Zero: Decision by Secretary of Energy
September 17, 2014

Passage of legislation focusing on environmental issues
December 21, 2014

• A tender process to award new areas (Round One) is expected by 2015; some extra-official sources predict at least one new round per year through 2025.

Secondary Legislation

• Full implementation of the Reform requires the Mexican Congress to pass additional secondary (implementing) legislation that will detail, among other things:
  - The contractual framework and bidding processes applicable to upstream exploration and production;
  - Local content requirements (for US companies the extent of these requirements will be limited by NAFTA and other international treaties);
  - Royalty structures and tax rates applicable to private participation and investment in the country’s energy sector;
Secondary Legislation (continued)

— How PEMEX will be transformed into a productive state company (e.g., financing, budgeting, corporate governance and transparency);

— The role and duties of the regulatory agencies charged with overseeing the energy sector;

— New environmental and safety regulations; and

— The creation and operation of the Mexican Oil Fund.

Secondary Legislation (continued)

• Existing laws that are expected to be amended:

1. Regulatory Law of Article 27 for Oil Activities (Ley Reglamentaria Art. 27 Constitucional en el Ramo del Petróleo);

2. Petroleos Mexicanos Law (Ley de Petróleos Mexicanos)
   — to include special procurement rules;

3. Organic Law of the Federal Public Administration (Ley Orgánica de la Administración Pública Federal);

4. Law of State Entities (Ley Federal de Entidades Paraestatales);

5. Law of the Electric Public Service (Ley del Servicio Público Energía Eléctrica);

6. Law of the Sustainable Energy Use (Ley de Aprovechamiento Sustentable de Energía);

7. Law for the Use of Renewable Energy and Financing for Energy Transition (Ley del Aprovechamiento de Energías Renovables y Financiamiento para la Transición Energética);
Existing laws that are expected to be amended:

8. Law of the Energy Regulatory Commission (*Ley de la Comisión Reguladora de Energía*);
9. Law for the Budget and Fiscal Responsibility (*Ley Federal de Presupuesto y Responsabilidad Hacendaria*);
10. Federal Law on Fees (*Ley Federal de Derechos*);
11. Mining Law (*Ley Minera*);
12. General Law on National Assets (*Ley General de Bienes Nacionales*);
13. Expropriation Law (*Ley de Expropiación*);
15. Law of Public-Private Associations (*Ley de Asociaciones Públicas-Privadas*);

Strategic areas currently reserved to the nation: hydrocarbon, basic petrochemical and electricity sectors, among others.

Foreign investment currently limited to 49% participation in the construction of hydrocarbon pipelines and drilling of wells, among others.
Secondary Legislation (continued)

• New laws that are expected to be enacted:

1. Law of State-Productive Companies (Ley de Empresas Productivas del Estado);

2. Law of Coordinated Energy Regulatory Agencies (Ley de Órganos Reguladores Coordinados en Materia Energética);

3. Law of the Mexican Oil Fund for Stabilization and Development (Ley del Fondo Mexicano del Petróleo para la Estabilización y Desarrollo);

4. Law on Hydrocarbon Fees (Ley Federal de Derechos sobre Hidrocarburos);

5. Law of the National Agency for Industrial Security and Environmental Protection for the Hydrocarbon Sector (Ley de la Agencia Nacional de Seguridad Industrial y Protección al Medio Ambiente del Sector Hidrocarburos);

6. Executive Order for the Establishment of the National Center of Natural Gas (Decreto de Creación del Centro Nacional de Control de Gas Natural);

7. Law of the National Center for Energy Control (Ley del Centro Nacional de Control de Energía);

8. Law on Transparency and Anti-Corruption in the Energy Sector (Ley de Transparencia y Combate a la Corrupción del Sector Energético); and

Taxes and Labor

• Taxes
  – Existing general tax regime is subject to amendments in the implementing laws concerning taxes specific to the hydrocarbons industry
  – Secretary of Finance recently announced (Davos) that the government will enter into tax stabilization agreements to provide certainty to the private sector.

• Labor
  – Existing labor laws are not expected to be amended in any material respect under the implementing laws.

NAFTA

• NAFTA affords U.S. companies a number of benefits and protections.
• NAFTA exclusion of Mexican energy industry under Chapter 6.
  – Nonetheless, investor protections are applicable under Chapter 11 (NAFTA Investor-State Arbitration).
• National Treatment Rule (Article 1102).
  – Applicable to local content requirements.
Challenges

• Fiscal regime for upstream contracts.
• Overregulation and stagnation by regulatory authorities.
• Environmental regulations.
• Labor issues (unions).
• Local content requirements.
• Corruption and security.
• Efforts by the Mexican left to block the Reform through a National Consultation (*Consulta Popular*).

– The Constitution, however, cannot be amended by a National Consultation.

Thank you!