



Mexico's Energy Reform: A Game Changer in the Nation's History (An Upstream Perspective)

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1. FUNDAMENTALS OF THE MEXICAN ENERGY REFORM

The Mexican energy reform bill adopted by a narrow margin on December 12, 2013 and which took effect on January 1, 2014 formalizes the most liberal energy regime in the country's history.

Framed by the far-reaching political agreement promoted by President Enrique Peña Nieto at an early stage of his administration, the "Pact for Mexico" (*Pacto por México*), the scope of the reform was already established. First and foremost, the hydrocarbons remain the country's property; will be extended the National Hydrocarbons Commission's (CNH) faculties; will be opened up to competition refining, petrochemistry and transportation; will lower electricity production costs through gas; will set up energy supplying in the country with reasonable prices and quality; and, last but not least, PEMEX will be converted into a public "Productive Company."

To summarize, the reform addresses three key aspects as follows:

- Authorizing private investment for exploration and extraction of hydrocarbons under contracts (i.e., Production Sharing Agreement) with the federal government, as further exposed herein below.
- Authorizing oil processing and refining by private companies as well as gas processing, oil and oil derivatives transportation, storage and distribution.

¹ I wish to thank my associates, Jorge Sandoval and Greg Miot for their collaboration in this article.

- Authorizing private investment for electricity generation, commercialization, transmission and distribution under contract with CFE (Electricity Federal Commission).

Despite the reform's innovative character, the core constitutional reservation, stemming from the hydrocarbons' ownership by the country and therefore prohibiting concessions, remains intact.

Indeed, the Mexican Constitution rules the exploitation of the country's resources through different—relatively open—areas to private investment, depending on the nature of the resource and the activity involved.

Hydrocarbons resources have always been carefully preserved and maintained in a narrow strategic area. Nonetheless, the energy reform cracked this historical shell to unfold a new oil and gas special strategic area thus offering new business opportunities.

2. CONTRACTUAL MODELS

Four different contractual arrangements have been introduced:

- Service contracts, with a cash compensation;
- Profit sharing contracts, with a compensation based on a percentage of profit;
- Production sharing contracts, with a compensation based on a percentage of production;
- License contracts, with compensation through licensing in return for payment for hydrocarbons extracted from subsoil. This feature, which could be linked with the traditional concept of “permit,” remains unknown in Mexican law. Moreover, the concept of “permit” does not fully cover the meaning that the license aims to bear.

The bill's final version also includes a fifth alternative allowing “*any combination of the aforementioned contracts.*” In this respect, it is likely that this provision may allow a wider flexibility and a greater similarity with the concession model. However such flexibility depends on the legal framework to be developed in the secondary legislation, expected by mid-2014.

Indeed the participation in the oil and gas industry is not mandatorily bound to these four pre-formatted models. Pemex is still entitled to directly contract and/or subcontract third parties by means of standard remunerated integrated services agreements or other standard forms. In the same way, the farm-out model remains a managing option for Pemex, depending on the strategic versus non-strategic importance of each oilfield in the framework of its exploration and production portfolio.

The reform extends the private sector's possibilities allowing for further operative innovation in the upstream sector in its entirety. As a combination of contractual arrangements, compensation schemes and special fiscal elements will be in effect shortly, it will be for the business community to generate the business opportunities in the sector.

3. PEMEX'S CONVERSION INTO A "PRODUCTIVE COMPANY"

According to the bill's transitional clauses, Pemex is expected to progressively become, within two years, a "Productive Company" (along with the Electricity Federal Commission, CFE). The purpose of this transition is for greater managerial and technical autonomy of Pemex, which would involve a special budget regime. Pemex would be subject to financial balance as well as income taxes, as any other private company.

The distinction implies, first of all, a greater relief for Pemex as it will benefit from a whole new governance approach and a tailor-made budget, and secondly, greater expected revenue for the federal government as the private sector is likely further economic value for the country.

However, this conversion inevitably forces Pemex to pass its oil and gas traditional power to the new manager of the resource: the National Hydrocarbons Commission (CNH), and the Energy Ministry, as the country's policy maker.

4. INSTITUTIONAL DESIGN

The institutional design rests on a trinity driven by the CNH in collaboration with the SHCP (Tax Administration, in charge of tax conditions related to public biddings and contracts) and the SENER (Energy Ministry, in charge of area selection, technical design of contracts, and technical guidelines of public biddings).

As per this new structure, CNH becomes the new key player in the Mexican oil and gas industry, being the new awarding authority for private companies as well as for Pemex (organize public biddings, assignments, contract executions, technical administration, and supervision of development plans).

This collaborative scheme also includes the SEMARNAT (Environment Ministry), which will act as a monitoring authority in the hydrocarbon sector, via a specialized agency.

The reform also brought a substantial modification with regard to the counterparty since each contract should be signed with the Federal State and no longer with Pemex. This means that, among other consequences, the negotiation stage will be carried out without the participation of Pemex's Trade Union (STPRM), which came out strongly weakened by the reform as it has also been dismissed from Pemex's governing bodies.

The new role that the CNH will carry out considerably diminishes Pemex's decision-making power. In fact, the CNH is in charge of two major duties:

- Identify and authorize which fields Pemex may exploit and who may accompany Pemex in their development, if Pemex so decides (Round Zero);
- Determine whether or not a field should be opened to public bidding, the awarding and management of the allocated fields (Round One and onwards);

Indeed Pemex will barely have a suggestion right as the CNH detains the power to have the last word as for the fields' assignments as well as for the partnerships, when Pemex decides to migrate its exploratory titles (*asignaciones*). In the same way, the contractual flexibility will mainly be regulated by the CNH along with the SENER, which should be in charge, among other matters, of the contracts' technical design.

5. OIL REVENUES

The oil revenues will be placed under control of the Bank of Mexico and invested into a "Mexican Oil Fund."

The fund will receive, upon tax payment, all revenues stemming from hydrocarbon's exploration and extraction. In this regard, a priority chain has been designed to organize its distribution.

For that purpose, the contractor's payment precedes any distribution. The following elements, ordered by priority, will be: fixed federal budget; debt sovereign payment and long-term savings.

Finally, if the net income exceeds 0.15% of the GDP, an investment program will be triggered (development, projects, pensions).

6. ROUND ZERO

As producing fields will be kept (due to public finance *status quo*), the reform allows a time-window for Pemex to select and submit to the CNH's approval, the exploratory fields of its interest. CNH would then grant Pemex exploitation titles (*asignaciones*).

The following main options are available to Pemex:

1. Request the migration of its exploitation titles into oil and gas contracts (i.e. Production Sharing Agreement, or PSA) in which Pemex would be part of a consortium with a private operator. Such consortium would then execute the said contract (i.e. PSA) with the country (via CNH).
2. Request exploitation titles without migration into oil and gas contracts. In so doing Pemex can either continue using traditional service contracts or enter into internationally-based oil and gas contracts (such as PSAs or other risk-based contracts) conducting its own bid rounds.

In addition to the above-mentioned options, Pemex has the right to migrate its exploitation titles at any time (not only during the Round Zero) with the CNH's approval. Further, when conducting Round One and onwards CNH might also decide to make the participation of Pemex mandatory.

In this regard, Pemex will also be required to meet the highest technical and financial requirements for exploration fields. CNH has the right to revoke Pemex's exploitation title after five years, if the activity was proven unproductive.

7. ROUND ONE AND ONWARDS

The CNH's assignment decision after Round Zero will clearly give way to the portfolio of fields left for the following rounds and will also give an indication as to the transition to an open market arena.

Round One will not include all fields, but probably the most significant ones in terms of prospective resources. Due to the maturity term, the level of CAPEX and other key factors, deep water fields might encompass Round One.

As per the Mexican law, the bidding may be organized either as an open international bidding process (Pemex's preferred form until now); a closed invitation to tender (to at least three companies); or, exceptionally through direct awarding. If public bidding benefits of its own set of rules, the CNH will have a free hand to set up the bidding context although the contracts' technical design should be SENER's task.

8. DEEPWATER PROJECTS

Deepwater projects are still under-exploited in Mexico since Pemex behaved cautiously and massive areas are yet to be de-risked.

Notwithstanding this prudent behavior, Mexico's deepwater prospective resources are high in the Gulf, with an estimated 26.56 MMBPCE. Some fields are in this regard particularly relevant: Perdido (100-600 MMboe in light crude oil); Holok (100-480 MMboe in gas and light crude oil) and Nox-Hux (90-250 MMboe in heavy crude oil).

9. SHALE GAS

According to the U.S. Energy Information Administration, Mexico is the fourth country with largest reserves of shale gas, after China, the United States and Argentina, and it is estimated to represent 6% of the world reserves of shale gas. The country plans to profit from this advantage.

Pemex's serious lack of advanced technology leads the national company toward the formalization of foreign partnerships. Due to the nature of Pemex's needs, it is fair to believe that partnerships are most likely to concern specialized companies skilled in hydraulic fracturing, horizontal drilling and other extraction techniques.

If deepwater projects related to shale gas may remain risky, plenty of onshore opportunities are available. The Burgos Basin is considered one of the country's most promising fields in shale gas and is currently arousing keen interest of private investors.

In any event, due to the low margins on shale gas, the awarding of fields by CNH might still take some time. Moreover, as Mexico does not have key comparative advantages vis-à-vis the United States in terms of shale gas, it is likely that only reservoirs which also include liquids are to be of interest for private operators. The shale gas market will definitively have a different momentum and characteristics than the case of the United States.

10. DOWNSTREAM AND MIDSTREAM OPPORTUNITIES

Another key element of this reform that should not be neglected is the development of midstream and downstream opportunities to be regulated, case by case, through a permitting regime. Even if the exploration and production business remains the major market, the reform clearly opens the other two levels of the oil-related business (midstream and downstream). Refining will be one of the key areas to be considered by long-term investors.

According to the SENER's 2011-2025 Natural Gas Market Prospective, a new strategy has been considered to intensify the use of natural gas. This new strategy involves the development of transport systems (pipeline networks) and compression facilities. In addition to these projects, distribution programs have been considered to develop distribution infrastructure and gas provisioning capabilities. Midstream activities have not been put aside and will offer wide possibilities.

Indeed, the secondary legislation will be decisive in this regard, since it will determine the basis and criterion of downstream activities (storage, transportation, oil pipelines building, petrochemicals, marketing, etc.). However, the improvement of national earnings is paramount and their maximization will rule the partner designation process.