

Mexican President Signs Historic Energy Reform into Law

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On Monday, August 11, 2014, Mexican President Enrique Peña Nieto signed a package of energy secondary laws passed by the Mexican Congress (the “Legislation”) that will overhaul the Mexican oil and natural gas, petrochemical, and power generation industries¹. The Legislation includes nine new laws and amendments to several current laws.

The cornerstones of the Mexican oil and gas reforms are the Hydrocarbons Law (*Ley de Hidrocarburos*) and the Hydrocarbons Revenue Tax Law (*Ley de Ingresos Sobre Hidrocarburos*). These new statutes regulate, among other items: (i) “entitlements” (*asignaciones*) granted to state-owned entities, such as Pemex; (ii) the types of exploration and production contracts that will be granted to Mexican and foreign operators as well as joint ventures between certain state-owned companies such as Pemex and private parties; (iii) the rules for the granting of such contracts and execution by the National Hydrocarbons Commission (*Comisión Nacional de Hidrocarburos* or “CNH”) through a public bid process; and (iv) the regulations for midstream and downstream activities, which will be overseen by the Ministry of Energy (*Secretaría de Energía* or “SENER”) and the Energy Regulatory Commission (*Comisión Reguladora de Energía* or “CRE”).

I. Upstream Sector Regulation **"Round Zero," Entitlements and "Round One"**

(i) Round Zero

During Round Zero, Pemex has a right of first refusal to retain development rights to areas in which it already has production or is actively exploring. Pemex submitted its Round Zero request to SENER in March 2014 asking to retain 100% of producing areas, 83% of proven and probable reserves, and 31% of prospective reserves.

On August 13, 2014, SENER granted Pemex all the producing areas, the proven and probable reserves requested (83%) and 21% of prospective reserves. Note that the deadline for SENER to answer Pemex’s request was September 17, 2014. The fact that SENER answered one month before the deadline is a clear sign of the Mexican government’s intention to speed up the implementation of the Legislation and the effectiveness of this energy reform.

The oilfields granted to Pemex include, among others, Grijalva, Ayin-Aux, Caan, Cardenas, Tamaulipas-Constituciones and Ek-Balam.

(ii) Entitlements

Through the entitlement regime established by the Legislation, the executive branch will grant Pemex or another “State Productive Enterprise” the right to develop certain fields for a set term. SENER will review requests and grant entitlements on an “exceptional” basis, which implies that Pemex could receive additional entitlements even after the Round Zero period. Private parties will still have a role to play in this entitlement regime as they will be permitted to enter into service contracts with Pemex on a cash payment basis.

SENER can also approve a migration of entitlements into exploration and production contracts. Should Pemex choose to migrate an entitlement into a contract, following approval by SENER, it would then be permitted to form a partnership with private parties for the purpose of developing the field. A bidding process to establish those partnerships would occur under the management of the CNH, which would determine the terms of the partnership. Pemex would not be authorized to choose its partners or conduct the bidding process.

(iii) Round One

This Round will focus on (a) projects in partnership with Pemex, once the relevant entitlement is migrated, and (b) new areas not requested by Pemex in Round Zero.

On August 13, 2014, Pemex announced that it will seek two joint ventures in the Perdido area, as well as partnerships in deep-water Lakach field and extra-heavy oil fields and mature fields. It will also look for partners in 10 projects where it lacks the technical and financial resources to develop fields on its own (farm-outs). It is expected that the partnership negotiations will start in November 2014 to be formalized within the following thirteen months.

The new areas not retained by Pemex will be bid by the CNH, including 109 blocks for exploration and 60 blocks for production, for an aggregate of 28,000 square kilometers. The preliminary bid guidelines for these blocks will be issued on November 14, 2014 and the definitive guidelines will be issued in the first quarter of 2015, when the bid process will officially start.

Exploration and Production Contracts

Exploration and production contracts will be granted to contractors through a competitive bid process.

The CNH will manage the bid process and ultimately award contracts. The Hydrocarbons Law and the Hydrocarbons Revenue Tax Law provide the following contract models: (a) service contracts; (b) licenses; and (c) profit- and production-sharing contracts.

(a) Service Contracts

Under a service contract, the contractor will deliver the hydrocarbons production to the government of Mexico in exchange for cash payments to be provided in each contract. Payment to the contractor will be made by the Petroleum Fund. No other fees or royalties will be included in service contracts.

(b) Licenses

A private exploration and production company can obtain a license (similar to a lease of mineral rights) either directly through a bidding process for non-Pemex controlled fields or through a joint venture with Pemex for fields Pemex has acquired under an entitlement.

The contractor shall make economic payments to the Mexican government as follows: (i) an upfront signing bonus to be determined by the Ministry of Finance (*Secretaría de Hacienda y Crédito Público* or “SHCP”); (ii) a monthly quota during exploration of \$1,150 pesos (approximately US\$100) per square kilometer which increases after 60 months to \$2,750 pesos (approximately US\$200) per square kilometer to incentivize the company to drill (the “Contractual Fee”); (iii) a royalty payment on production once production begins (described below); and, (iv) a compensation determined as a percentage of operating profit. The amounts referred to in (i) and (ii) above will be annually updated in accordance with the Mexican Consumer Price Index.

The contractor will have the right of the transfer of the hydrocarbons that have been extracted from the subsurface.

(c) Profit-Sharing and Production Sharing

With respect to profit- and production-sharing contracts, a contractor will have to pay: (i) the Contractual Fee; (ii) royalties on production once production begins (as describe below); and (iii) a compensation determined as a percentage of operating profit.

The contractor shall have the right to (i) recover its costs, subject to certain provisions under the law; and (ii) the remainder of the operating profit, after paying the compensation to the government mentioned in (iii) of the preceding paragraph.

In profit-sharing contracts, the contractor shall deliver all of the production to the marketing company hired by the CNH, which shall deliver the sale revenues to the Petroleum Fund. The Petroleum Fund will retain the payments owing to the Mexican government and shall pay to the contractor the remainder of the operating profit mentioned in (ii) of the preceding paragraph.

In production-sharing contracts, the payments to the contractor will be in-kind equivalent to recoverable costs and its share of operating profit, delivering the remainder to the marketing company hired by the CNH, which shall deliver the sale revenues to the Petroleum Fund.

Royalties

The applicable royalty rate for petroleum described above in regard to licenses, profit-sharing and production-sharing contracts will be determined based on the price per barrel. If the price per barrel is below US\$48, the royalty rate is 7.5%. If the price per barrel is US\$48 or above, the royalty rate is equal to $[(0.125 \times \text{price per barrel}) + 1.5]\%$. For example, if the price of oil is \$100, the royalty rate is 14%.

For associated gas produced from a predominantly oil well, the royalty rate is the price of gas divided by 100. For gas produced from predominantly gas wells, the royalty rate is calculated according to the following criteria. If the price of gas is equal to or below US\$5 per MBtu, the royalty rate is 0%. If the price of gas exceeds \$US5 per MBtu, but is less than \$5.50 per MBtu, the royalty rate is $=[(\text{price} - 5) \times 60.5] \text{ divided by the price} \%$. When the price exceeds

US\$5.50 per MBtu, the rate is equal to the price divided by 100.

National Content

A significant component of this reform process will be the requirement that energy projects must be comprised of 25% national content by 2015, a target that will rise to 35% by 2025, except for deep and ultra-deep water projects that will be evaluated by the Ministry of Economy with advice from the Ministry of Energy.

Booking of Reserves

Contractors will be allowed to book their exploration and production contracts for accounting and financial purposes, as well as the expected benefits from such contracts; provided, however, that at all times, the hydrocarbons located in the subsoil will be considered property of the Mexican State.

II. Midstream and Downstream Regulation

In the midstream and downstream markets, oil refining, natural gas processing, manufacturing petrochemicals, and transportation, storage and distribution of hydrocarbons and petroleum products will be fully open to private investment through the granting of permits by SENER or by the CRE as follows:

The CRE will issue permits for transportation, distribution, storage, compression, regasification, and retail sale of crude oil, natural gas, petroleum products, and petrochemicals.

SENER will issue permits for, among other things, (i) import and export of crude oil, natural gas and petrochemicals; (ii) refining of petroleum; and (iii) processing of natural gas.

The Hydrocarbons Law calls for open access and competition for midstream activities. Specifically, the law states that all providers of transportation, distribution, or storage services, shall provide open and non-discriminatory access to their facilities. Moreover, the law seeks to encourage competitive pricing and competition among market players.

The National Center for Natural Gas Control (“CENEGAS”) will be created to act as independent manager of the national integrated natural gas transportation and storage system, with the purpose of guaranteeing the continuity and safety of the supply of natural gas in Mexico. .

III. Real Estate Provisions

The hydrocarbon industry is a public interest, and, therefore, the State authorizes the imposition of legal easements and occupation of land for the performance of hydrocarbon-related activities.

The consideration, terms and conditions for the use and occupation of the land, goods, or rights that are necessary to conduct the exploration and production activities shall be negotiated and agreed with the owners, possessors, or holders of title of such land, goods, or rights, including agrarian (*ejidos*) rights. Additionally, the acquisition of the land, goods or rights can also be agreed between the parties.

The consideration to be paid to the owners/title holders shall consist of: (i) compensation for affecting rights and goods other than land and the expected damages and loss of profit; (ii) rent

for the occupation, easement or use of the land; and (iii) for hydrocarbon upstream activities, a percentage of the income that the contractor receives, which shall be a guaranteed minimum of 0.5% and a maximum of 2% (3% for gas produced from predominantly gas wells). Such payments shall be made in (a) cash; (b) in commitments to build infrastructure projects for the benefit of the community; (c) any other consideration allowed under the law; or (d) a combination of all of them.

In the event that the parties do not reach an agreement within 180 calendar days following the day when the contractor notifies the land owner of its intention to use or acquire the land, the contractor can (i) submit a request to the competent court for the imposition of a legal easement; or (ii) request that the Agrarian Ministry mediate the process.

IV. Final Comments

The next steps are the issuance of regulations, guidelines, administrative rules and forms of agreements needed in order to make the Legislation fully effective, a process that will take several months.

¹ This client alert only addresses the energy reform related to oil and gas. A client alert describing the reforms to the power industry will be prepared separately.