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Mexico: Energy Reform

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The Pemex Law and Related Measures – What Energy Reform Means for Mexico

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Background on Oil and Gas Sector

The Mexican Constitution reserves to the State the exploration and production of all hydrocarbons located in Mexico. Nationalized in 1938 by President Lazaro Cardenas, the oil industry has become a source of national pride and a symbol of the wealth and patrimony of the Mexican people. It is considered a “strategic activity” by the Mexican Constitution, and to that effect is strictly reserved to the State. Private participation in the sector is very limited. Specifically, the State has the exclusive right to (a) explore, exploit, refine, and process crude oil and natural gas, (b) produce basic petrochemicals and liquid petroleum gas (LPG), and (c) carry out first-hand sales of such hydrocarbon products.

The Mexican government performs oil and gas related activities through its national oil company, Petroleos Mexicanos (PEMEX), and its four vertically integrated subsidiaries: *Pemex Exploración y Producción*, *Pemex-Refinación*, *Pemex Gas y Petroquímica Básica*, and *Pemex Petroquímica*. Basically, private parties may participate in this sector only as contractors, through construction, procurement, or services contracts with PEMEX or any of its subsidiaries. PEMEX may enter into contracts with private parties, but by statute all contracts must be paid in cash. Private parties are prohibited from receiving an ownership interest in the production or results from the operation.

Decline of Cantarell Oil Field

However, the long-term viability of this constitutional framework, and in particular the ban on risk contracts, has been called into question by the dramatic decline of the Cantarell oil field, Mexico’s most productive and one of the world’s largest producing oil fields.¹ Located in the shallow waters of the Bay of Campeche, production at Cantarell started in 1979, but output began to decline

by the mid 1980s. Daily production was 2.3 million bbl/day in 2004, which represented 63% of Mexico’s crude oil production.² Most analysts believe that the production decline in Cantarell is irreversible.

The decline of the Cantarell oil field also has serious implications for the Mexican federal budget. The Mexican Government has historically relied heavily on PEMEX for general revenue needs, and to this effect the government receives approximately 60% of Pemex’s gross revenue, and in recent years this has amounted to 110% of the company’s net income.³ Despite being a monopoly, Pemex has consistently recorded losses in recent years, even when international oil prices were high. Consequently, PEMEX depends on governmental appropriations and borrowings for new investment. This lack of capital has prevented it from investing in new technologies that could help it carry out deep water projects, which offer the best opportunity for large undiscovered finds.

In fact, these failures are arguably affecting Mexico at the present time. Mexico’s prized investment level credit rating may be vulnerable, as rating agencies assess the country’s vulnerability to lower oil prices and declining production.⁴ For example, PEMEX contributed 37% of government revenue in 2008 and the 60% reduction in oil prices from a July 2008 record helped contribute to Mexico’s budget deficit of 149 billion pesos (US\$ 11.3 billion) in the twelve months through March 2009, compared to a 3.3 billion peso surplus for the prior twelve month period.

Adoption of Recent Pemex Law *General Principles of the Reform*

In response to these and other factors, the Mexican government reformed PEMEX’s legal framework by amending laws and regulations that govern PEMEX’s activities. As part of this reform, in November 2008,

Mexico adopted the PEMEX Law, which created a new legal framework for its national oil company. The main goal of the reform is to transform PEMEX from a bureaucratic company, constrained and limited by excessive governmental regulations, to a more agile state-owned company that has the necessary flexibility to operate and compete in the international oil and gas market. On the other hand, this reform does not change the constitutional principles that reserve oil production to the Mexican government, and hence many independent observers remain skeptical as to whether this measure will accomplish these lofty goals.

The reform introduces four legal and structural changes: (a) special public administration regime, (b) corporate governance reforms, (c) operational autonomy, and (d) special contracting reforms. These concepts are discussed further below.

(a) Special Public Administration Regime. The PEMEX Law seeks to transform PEMEX into a state-owned company with sufficient flexibility to operate in a competitive market, in part by authorizing it to adopt its own regulations to operate (subject only to some broad restrictions discussed below), without violating fundamental constitutional principles. As such, PEMEX will operate pursuant to its own internal regulations (to be adopted), as opposed to those that apply to general quasi-governmental entities. Nevertheless, where PEMEX's new regulations are silent, regulations that apply to general quasi-governmental entities will continue to apply.

(b) Corporate Governance Reforms. Pursuant to the PEMEX Law, the company's board of directors is composed of fifteen (15) members⁵ consisting of six (6) representatives of the Mexican State appointed by the President,⁶ five (5) representatives appointed by the PEMEX union,⁷ and four (4) professional directors appointed by the President and ratified by the Senate.⁸ PEMEX's General Counsel will serve as the Board's Secretary.

The goal of the new structure is to create a less politicized decision-making process. With the addition of the four professional board members, the goal of the PEMEX Law is that PEMEX make important decisions from a more technical perspective.

The PEMEX Law seeks to strengthen PEMEX's internal governance in two significant aspects:

(i) **Authority of the Board of Directors.** In the interest of achieving greater autonomy, under the reforms, the PEMEX board of directors will now have greater authority over PEMEX's management. In particular, PEMEX will adopt its own annual budget, instead of having to depend on obtaining authorizations from the Ministry of Finance and Public Credit (Secretaria de Hacienda y Credito Publico or "SHCP"). Furthermore, the board of directors now has an array of significant powers to

carry out PEMEX's operations, and several committees presided by professional directors will assist the board to this effect.⁹

(ii) **Adoption of Best Corporate Practices.** Although this concept is not a novel one, it has not been fully implemented in Mexican quasi-governmental entities such as PEMEX. The PEMEX Law seeks to enhance Board oversight and control, which constitute a significant change from the manner in which PEMEX and its subsidiary entities previously operated, particularly with respect to the decision-making process and the relationship with management.

(c) Operational Autonomy. Third, the PEMEX Law seeks to advance operational autonomy (and by implication enhanced efficiency), particularly in the financing and budgeting areas. The public policy consideration was that PEMEX needed more decision-making flexibility, particularly in strategic areas, such as financing and budgeting, in order to move away from its historic dependence on the Mexican Treasury.

In particular, with respect to financial issues, certain significant rules that re-define PEMEX's ability to obtain credit have been adopted:

(i) **Own Financial Program.** PEMEX has been given authority to prepare its own financial program, consistent with the General Law of Public Debt (Ley General de Dueda Pública) and subject to the annual limits established by the Mexican Congress. Regarding budgetary issues, the PEMEX Law grants more authority to the PEMEX board to develop and approve its own budget. On one hand, under certain conditions, the approval previously required by the Mexican Treasury under the Federal Law of Budget and Financial Responsibility (Ley Federal de Presupuesto y Responsabilidad Hacendaria) is no longer required.¹⁰ On the other hand, as discussed below, the PEMEX Law grants PEMEX more flexibility in contracting with its Mexican suppliers and contractors.

(ii) **More Authority to Obtain Financing from External Sources.** PEMEX has been given the authority to obtain financing from external sources, such as the capital markets, without the need for approval by the Mexican Treasury, provided that no rights over Mexican hydrocarbons are granted to creditors. However, significantly, PEMEX will not be permitted to use financing that relies on the full faith and credit of the Mexican Government.

(iii) **Citizen Bonds.** PEMEX is authorized to issue "citizen bonds," which although not expected to be a major source of capital due to the relatively small size of the Mexican capital markets, may create a closer link between the Mexican public and PEMEX's operations. Interestingly, these bonds will grant their holders a return linked to the entity's financial performance.

(d) Special Contracting Regime. Finally, the PEMEX

Law grants Pemex (but not other para-statal) a new regime for the procurement of goods and services. For activities that are not deemed part of the oil industry reserved to the State, the general regime for acquisitions and works of the public sector remains the same. With this new special contracting regime, subject to the previously mentioned restrictions, PEMEX may establish the bid terms, criteria, and contract models which best meet the needs of the particular services or works that govern the international market in this industry.

To this effect, as part of the implementation of this change, the Public Works Law (“Ley de Obras Públicas y Servicios Relacionados con las Mismas”) and the Procurement Law (“Ley de Adquisiciones, Arrendamientos y Servicios del Sector Público”) have been amended to exclude from such laws, public works and procurement contracts entered into by PEMEX in connection with the oil and gas industry.

In addition, PEMEX’s board of directors now has the authority to issue administrative regulations to govern procurement and public works related to contracts within the range of activities of the oil industry reserved to the State, which will be published in the Federal Official Gazette. These regulations must comply with the general procurement contracting principles of article 134 of the Mexican Constitution, which basically mandate that government contracts will be awarded through public bidding procedures or, with limited exceptions, through restricted bidding procedures, or direct awards. In any event, in all contracts executed by PEMEX, public officers have the responsibility to assure that PEMEX is getting the best available conditions regarding price, quality, financing, opportunity, and other relevant terms and conditions.

PEMEX and its subsidiaries, in performing the activities reserved to the State, may enter into contracts, subject to certain conditions provided in the PEMEX Law, which shall assure the State’s sovereignty over hydrocarbons, such as: (i) No rights shall be granted over hydrocarbon reserves, therefore suppliers or contractors may not book the reserves on their financial statements; (ii) Payment shall always be made in cash, and no percentage in the production, sales, or profits may be agreed upon as a payment method; and (iii) No production sharing contracts or any other type of association compromising the reserves will be allowed.

However, it is important to point out that the new PEMEX Law allows for PEMEX to include in its procurement and construction contracts clauses for additional compensation to the contractor in instances where the contractor performs efficiently and provides economic and technical benefits to PEMEX. In any event, this additional compensation must be paid in cash and spe-

cifically be provided for in the respective contract at the time of execution.

Other Relevant Aspects of the Reform

As part of the reform of November 2008, Mexico also amended several other laws with the goal of developing the energy sector, without changing the constitutional principles that reserve energy resources to the Federal Government.

National Hydrocarbon Commission

The Law of the National Hydrocarbon Commission provides for the creation of the National Hydrocarbon Commission (*Comisión Nacional de Hidrocarburos*) as an entity (*órgano desconcentrado*) of the Ministry of Energy. Its purpose is to regulate and supervise exploration and production of hydrocarbons in Mexico, and the processing, transportation, and storage of these products.

In complying with this purpose, this Commission shall act pursuant to the National Energy Strategy and carry out its mandate, making sure that PEMEX and its subsidiaries carry out exploration and production activities using the most suitable technology, according to economic and productive principles, environmental protection, and sustainability of natural resources. The Commission’s most important authorities include:

(a) Provide the technical elements for the design and definition of the country’s hydrocarbon policy, as well as for the preparation of sector plans with respect to hydrocarbon exploration and production, according to the policy adopted by the Ministry of Energy;

(b) Collaborate with the Ministry of Energy in the determination of the policy for the restoration of hydrocarbon reserves;

(c) Establish technical standards for exploration and production of hydrocarbons, within its scope of authority, and verify the compliance thereof;

(d) Perform technical studies prior to the assignment of exploration fields to PEMEX by the Energy Ministry; and

(e) Maintain an oil registry that contains records of adopted resolutions, areas assigned to PEMEX, oil reserve zones, etc.

The Commission will be composed of five commissioners appointed by the President for a five-year term, renewable on one occasion for a term of the same length. The law provides that the Commission will be duly established within 90 days of November 28, 2008, and is to be fully operational no later than 180 business days from November 28, 2008. This Commission was officially installed on May 20, 2009 with the announcement by Georgina Kessel, Minister of Energy, of the five commissioners that were appointed by President Felipe Calderón.¹¹ The

Commission will adopt its internal regulations in order to formally commence in August 2009.

Energy Ministry's New Authority

As part of the above-mentioned amendments, article 33 of the Federal Public Administration Organization Law (*Ley Orgánica de la Administración Pública Federal*) was also amended to grant additional authority to the Ministry of Energy, necessary under the newly enacted laws and reforms for:

a. The carrying out of the country's energy policy, as well as the oversight of compliance, with emphasis on energy security, diversification, and environmental protection;

b. The development of mid-term and long-term energy plans; preparation of social and economic guidelines for the state-owned companies of the energy sector, focusing on aspects related to energy sovereignty and security, improvement of energy productivity, restoration of hydrocarbon reserves, progressive reduction of environmental impacts in energy production and consumption, greater development of renewable energies, satisfaction of basic energy needs of the population, energy savings, greater efficiency in production and consumption, strengthening governmental entities in the energy sector, support to national technological research and development; and

c. Forming the National Energy Council and issuance of its rules of operation,¹² promotion of energy savings, and issuance of norms for modernization, efficiency and development of the sector, regulation and promotion of the development and use of alternative energy sources and promote the corresponding incentives.

New Authority for the Energy Regulatory Commission

Amendments to the Law of the Energy Regulating Commission (*Ley de la Comisión Reguladora de Energía*) have also granted the Energy Regulatory Commission (*Comisión Reguladora de Energía*, "CRE") more decision-making autonomy to complement the operational and technical autonomy that it previously had prior to the reform. In addition to its obligation to promote the efficient development of the regulated activities regarding gas and electricity, the CRE also now has the authority to regulate the first-hand sale of fuel oil and basic petrochemicals. The regulation of transportation, storage and distribution of oil-refined products and biological fuels, when such activities are carried out through pipelines, was also added.

Law for the Use of Renewable Energy and Financing the Energy Transition

The Law for the Use of Renewable Energy and the

Financing of the Energy Transition (*Ley para el Aprovechamiento de Energías Renovables y el Financiamiento de la Transición Energética*) was adopted to regulate the use of renewable energy and clean technologies for the generation of electricity for uses other than rendering of the "public service" of electric power, as well as to set forth the national strategy and instruments for the financing of energy transition.

The Energy Ministry is to adopt a strategy focused on the primary use of renewable energies to generate electric power. The term "energy transformation" implies the promotion by the State of energy efficiency and sustainability, as well as the reduction of the use of hydrocarbons as a primary energy source. According to this law, renewable energies include wind, solar, water movement, oceanic energy (tidal power, tide-thermal power, waves, etc.), heat from geothermic fields, bioenergetics, and any other forms of energies determined by the Energy Ministry.

In addition, the CRE has the authority under this law to issue the norms, standards, guidelines, methodologies, and other administrative provisions governing electricity generation from renewable energies, according to the energy policy set forth by the Ministry of Economy. The criteria to determine payment for bio-fuels utilized in the generation of electricity is to be coordinated by the CRE with the Mexican Treasury. Among the CRE's duties in this aspect, there is the authority to issue methodologies to determine the provision of the generation capacity of renewable energies to the National Electric System.

Law to Promote Sustainable Use of Energy

The purpose of the "Law to Promote Sustainable Use of Energy" (*Ley para Promover el Aprovechamiento Sustentable de Energía*) is to achieve sustainable development of the energy industry, through its optimal use in all its processes and activities, from exploitation to consumption. The President is to establish the strategies, objectives, and measures, of energy conservation under a special program by the name of National Program for the Sustainable Use of Energy.

The National Commission for the Efficient Use of Energy (*Comisión Nacional para el Uso Eficiente de la Energía*), which replaces the National Commission for Energy Savings (*Comisión Nacional para el Ahorro de Energía*), is an organization within the Ministry of Energy with technical and operational autonomy, granted the mandate to promote energy efficiency.

The Consulting Council for the Sustainable Use of Energy (*Consejo Consultivo para el Aprovechamiento Sustentable de la Energía*) is an advisory body of the Commission, with the purpose to evaluate the compliance of objectives, strategies and actions set forth in the Program.

This council is formed by the Minister of Energy and six academic researchers.

Gas Associated with Mineral Carbon Deposits

Gas Associated with Mineral Coal Deposits, also called in Mexico *gas grisú*, is primarily composed of methane. The regulation of this gas is within the authority of the Ministry of Energy and the Ministry of Economy, through the Regulatory Law of Article 27 of the Mexican Constitution Regarding Oil and the Mining Law (*Ley Minera*). Its use is restricted to internal use by the holder of the mining concession, or sale to PEMEX. However, the sale to third parties by the concession holder is not allowed.

In December 2008, the implementing regulations for *gas grisú* were published. To this effect, the Ministry of Energy has been granted authority to issue permits and guidelines for the consumption of the gas by the mining concession holder or for its supply to PEMEX.

1 See "Mexico Cantarell oil field output falls again in May," citing a Mexican Energy Ministry report indicating that oil production for the field fell in May 2008 for the eighth month in a row to 1.038 million barrels per day, its lowest level in twelve years," Reuters.com, June 26, 2008.

2 See "Energy Cooperation in the Western Hemisphere," edited by Sidney Weintraub, p. 115 (2007).

3 Weintraub, p. 107.

4 See "Mexico Faces Downgrade after 'Very Complacent' Decade," Valerie Rota and Carlos Manuel Rodriguez, May 12, 2009, Bloomberg.com.

5 Previously, the board was composed of six representatives designated by the President and five representatives designated by the union, a nod to the grand coalition put together by the PRI, Mexico's ruling party for approximately 70 years.

6 Currently, the directors appointed by the Mexican State are Georgina Kessel, who serves as president of the Board (Ministry of Energy), Agustín Carstens (Treasury Ministry), Gerardo Ruiz Mateos (Economy Ministry), Patricia Flores (Director of the President's Office), Ernesto Cordero (Ministry of Social Advancement), and Salvador Vega (Ministry of the Public Comptroller).

7 The board representatives designated by the Pemex union are Ricardo Aldama, Fernando Pacheco, Jorge Wade, Hector Manuel Sosa, and Pedro Garcia.

8 In March 2009, the four professional Board members were announced and subsequently approved by the Congress. These individuals, serving staggered terms, are: (a) José Fortunato

Álvarez (6-year term)(he has previously served as the head of the PEMEX's Internal Control Office, as a congressman, and held several positions in Baja California's Government; (b) Hector Moreira Rodriguez (5-year term) (he has previously served as the Vice-Dean of the Investigations and Technology Departments of the *Tecnológico de Monterrey*, Vice-Secretary of Hydrocarbons for the Ministry of Energy, and Chief of Vicente Fox's office of Strategic Planning; (c) Rogelio Gasca Neri (4-year term)(he formerly worked as a politician and businessman, including as Minister of Budget for ex-President Carlos Salinas' government, president of the Federal Electricity Commission, and most recently, as president of the holding company that controlled Aeromexico and Mexicana (Mexico's largest airlines); and (d) Fluvio Ruiz Alarcón (3-year term)(he is a member of the Citizen Energy Observation and Study Commission, and acted as advisor for the PRD on energy matters as part of the negotiations for the new PEMEX's legal framework.

9 Article 19 of the PEMEX Law provides a long list of duties and authority granted to the board of directors, including: issue guidelines to regulate the relationship between PEMEX and its subsidiaries, manage PEMEX's according to best industry practices, and issue internal regulations for contracting procurement and construction contracts.

10 Article 49 (III) of the PEMEX Law provides that the board of directors may authorize to increase budgeted expenditures, if PEMEX's own profit exceeds projected income, without the need to obtain other governmental authorizations.

11 The five new commissioners are (i) Juan Carlos Zepeda Molina (President), (ii) Edgar René Rangel Germán, (iii) Javier Humberto Estrada Estrada, (iv) Guillermo Cruz Dominguez Vargas, and (v) Alfredo Eduardo Guzmán Baldizán.

12 The National Energy Council is composed of the head of each governmental entity of the energy sector (i.e. PEMEX, CFE, CRE, National Water Commission, etc.). The purpose of the Council is to assist the Energy Ministry in establishing national energy policy.

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