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## Energy & Natural Resources - Mexico

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### Energy Reform Package to Transform Oil and Gas Exploration and Production

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After several months of debate, Mexico's energy reform has been approved by the Senate and the House of Representatives. The eight federal statues implementing it are expected to be enacted shortly. The reform focuses on the oil and gas industry - particularly the role and organization of Pemex, the state-owned oil and gas company - but also covers renewable energy projects.

### Regulatory Agencies for Exploration and Production

Mexico has never had an upstream authority and Pemex, as the sole exploration and production operator, has been subject to limited supervision in these areas. Except in the electricity sector, no long-term or medium-term energy policy or planning strategy has been applied; rather, decisions on projects have been based largely on the Ministry of Finance's assessments of the likely short-term revenues. This has resulted in dramatic decreases in reserves and a consequent steep decline in the output of the main production fields. The latest structural changes will reshape the oil and gas industry's framework and facilitate the implementation of further reform.

The National Hydrocarbons Commission has modelled on similar institutions in Brazil and Norway. Among other things, the commission will be entrusted with:

- regulating and supervising the exploration and production of hydrocarbons;
- granting technical approval for all such projects, including the technical review and approval of Pemex's operating licences;
- determining the production levels and setting the programmes and ratios for Mexico's reserves;
- preparing and enacting official technical standards for exploration and production and supervising compliance with such standards;
- maintaining official statistics and records for exploration and production operations; and
- registering all major exploration and production contracts and ensuring that the parties comply with their terms.

The commission will comprise five presidential appointees and is expected to begin operations within 180 days

of the reform being published.

The secretary for energy has been given broader authority to regulate Pemex and the energy industry in general, particularly with respect to the oil and gas industry and energy planning and policy.

A National Energy Council, presided over by the secretary for energy, will be established to represent all federal agencies and public entities that are directly involved in the industry, including Pemex, the Federal Electricity Commission, the Energy Regulatory Commission, the National Water Commission and Central Light and Power. The council will be charged with preparing and implementing a 15-year national energy plan, to be resubmitted for ratification to Congress every February; the first plan is due for submission in 2010. A consultative committee will allow private-sector entities and others to participate in the council's work.

In addition to its role as independent regulator of the natural gas midstream and downstream industries and the electricity sector, the Energy Regulatory Commission is now vested with the authority to:

- regulate pipelines and terminals for liquid fossil fuels and biofuels, including rates and terms and conditions of service;
- regulate the first-hand sale of fuel oil and basic petrochemicals; and
- implement and regulate the reform of the renewable energy sector.

### **Reform of Pemex**

As a public entity under federal control, Pemex has had limited flexibility and few incentives to operate like an international oil company. One of the main changes introduced by the reform is the adoption of a series of corporate governance rules and principles that aim to replicate the structure of a public company in order to enhance Pemex's economic position.

#### ***Independent board members***

In keeping with Organization for Economic Cooperation and Development recommendations, 25% of Pemex's board of directors will be independent professional board members, nominated by the president and approved by the Senate.

#### ***Internal committees***

Committees will be formed with responsibility for areas including:

- auditing and performance;
- compensation;
- strategic investment;
- transparency;
- environmental issues and sustainable development; and
- procurement.

The committees will be chaired by a professional board member with specific duties established by law. Pemex's activities and performance will be reviewed by commercial standards, not in terms of its status as a government agency. The auditing function of the Bureau of the Federal Comptroller, which has hindered projects in the past, has been restricted so that Pemex's performance can be judged by the criteria applicable to a commercial oil and gas enterprise.

#### ***Decision-making authority***

The board will be given greater authority over the running of Pemex, including considerable decision-making power in respect of contracting foreign and domestic debt and approving investments and business plans. Investment decisions and debt approval have hitherto been the Ministry of Finance's responsibility. The board of directors will have exclusive authority to approve Pemex's budget, except in limited cases and in respect of certain reporting obligations. Board decisions must be approved by an overall majority and a majority of the professional members.

### **Citizen bonds**

The new law states that one of Pemex's main purposes is to maintain and increase its own economic value. However, Pemex has never operated as a public company - that is, it has never disclosed its financial accounts, performance reports, programmes or plans to potential investors or the public. A significant advantage of the reform is the creation of citizen bonds - publicly traded debt instruments with a yield linked to Pemex's performance. The most immediate benefit will be that Pemex will share part of its profits with Mexican citizens, treating them to some extent as shareholders receiving a form of dividend. However, the main medium-term advantage will be that market participants and bondholders will create market pressure on Pemex to match expectations about its performance, conform to its business plan and generally act as a company with a business purpose, not as a political tool. Funds raised from citizen bonds will be earmarked for investment in productive infrastructure projects that comply with certain return criteria. Furthermore, the president will appoint a statutory examiner to protect bondholders' interests and provide reliable information about Pemex's performance.

### **Investment structures**

Pemex may no longer enter into contracts for productive long-term infrastructure projects under the Pidiregas regime. The liabilities arising from contracts into which Pemex enters will be deemed to rest exclusively with the company and will be excluded from the federal budget for balance purposes. In recognition of the special need for investment to develop the Chicontepec field and certain deep-water projects, the reform introduces a special regime whereby Pemex's activities in such areas will be eligible for additional tax deductions and higher limits on deductions.

### **Contracts**

Under the new legislation, Pemex's core business contracts are exempt from procurement laws and the board of directors will draft rules and procedures for awarding and structuring such contracts. This will allow Pemex to set its own rules and modify them as industry practices develop without the need for changes in legislation. The fact that the rules will be issued by a procurement committee led by an independent board member is encouraging. Mexico's procurement laws are highly restrictive and inappropriate for the oil and gas industry, whereas Pemex is likely to attempt to introduce contract rules that amend industry standards and make such contracts attractive enough to secure investment from the private sector. Pemex urgently needs to increase its 'proved, probable and possible' reserves and maintain, if not raise, its production level of 2.8 million barrels a day, as production from its largest field, the Cantarell field, is declining sharply. Although Pemex must still award most contracts by public tender, the reform provides for new exceptions that allow contracts to be awarded directly in more cases. Alliances with private parties are permitted in areas of the oil and gas industry that are not exclusively reserved to the state.

Consideration payable to contractors must be in cash and production-sharing agreements are not permitted. However, Pemex may enter into any form of contract where the contractor's compensation is determined by performance criteria, such as production, productivity and efficiency - this will be particularly relevant to exploration and production contracts. Although such incentive-based contracts are subject to certain statutory restrictions, they give Pemex significant scope to agree on various types of payment scheme that may attract contractors while giving Pemex more efficient rates of recovery, production and reserve replacement.

### **Renewable Energy**

Among other things, the Law on the Use of Renewable Energies and the Financing of Energy Transition aims to:

- encourage renewable energy projects;
- provide financing tools;
- promote the gradual replacement of fossil fuel-based generation;
- establish principles regulating the compensation payable for land used for wind farms and other renewable energy projects; and
- provide rules to facilitate the connection of renewable energy projects to the national grid.

The Law on the Sustainable Use of Energy is intended to promote efficient energy use and the development of new energy-efficient technologies.

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