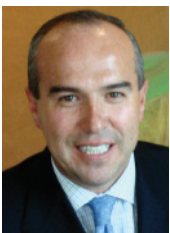


# Mexican energy: overhaul reform passed

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As this article goes to press, the Mexican Congress finally passed a long-awaited reform of the energy sector, with a significant national consensus. In the midst of the world economic and financial crisis, the revamping of the Mexican energy sector can be expected to boost the Mexican economy and growth in the sector. While for many the reform may have come too shy from what is needed to overturn Mexico's decline in crude oil production and an overhaul of its refining, petrochemical and midstream infrastructure, the reform is indeed a major step in the right direction towards the reorganisation of the market and a more productive and active participation of all the relevant players.

The reform implements major changes in the manner in which *Petróleos Mexicanos* – the national oil company, known by its acronym as Pemex – undertakes the exploration and production of crude oil and gas both onshore and offshore, and how it implements almost any midstream or downstream project. It also provides for a whole new corporate governance framework for Pemex, allowing for more financial autonomy to determine investments, to finance in the international markets and to provide more transparency in its management.

A series of measures are also expected to align the performance of Pemex with principles such as performance profitability and accountability. At the same time, the reform is aimed at curing an apparent systemic flaw: in a major oil production country, one of the world's largest producers has typically operated in an

un-regulated environment. The reform will create an upstream regulator that can determine production programmes (including reserves, substitution levels, E&P programmes, technology, among others) from a technical standpoint. The reform also recognises the importance of a gradual substitution of fossil fuels in the worldwide markets as a result of global warming and emerging technologies, and implements a framework to foster the diversification of energy sources and the implementation of renewable energy projects.

While we cannot touch on each important change, among others the reform addresses the following important points:

### Incentive-based contracts

PEMEX has historically been limited with regard to the types of contracts that it could implement with its contractors, which are usually oilfield service companies, both domestic and international. These companies are exposed to differing types of schemes in the various oil producing jurisdictions: of these probably the most restrictive (prior to the reform) was Mexico, where the law impeded any possibility of contracts with incentives for the contractors. However, as part of the new Pemex Law, Pemex will be able to agree on incentive-based contracts with the following limitations:

1. Consistent with the Constitutional restrictions, no risk contracts or standard profit sharing agreements may be executed. Neither can Pemex execute any arrangement where the oil revenues are distributed among Pemex and the contractors.
2. Contractors may not be given preferential rights or conditions with respect to the purchase of future production.

3. The contractors' consideration may not be linked to the value of the oil in the market, or otherwise to the revenues or profit obtained by Pemex from such sales.
4. While the reform contemplates that the contractor will not be able to book reserves as their own assets, for domestic law purposes, contractors will need to analyse how their consideration based on the level of production or on the amount of reserves found can be accounted for with respect to their own financials.

While the above-mentioned limitations may sound restrictive the law provides significant room to design incentive-based formulas for paying the contractors, which can reward efficiency, technology innovation, quality, and accountability, among various other matters. As opposed to the former scheme, where many objected to the payment of 'per-barrel fee' arrangements, the scheme is expected to provide a materially better environment for reaching production efficiencies, that allows Pemex to recover production and exploration levels, while rewarding contractors at the same time in a much fairer scheme.

In addition to incentives, Pemex has traditionally faced many problems with contractors because of a lack of flexibility with respect to the adjustment of prices due to market fluctuations, change of market conditions and other considerations. Paradoxically for Pemex, the restriction aimed at providing more certainty as to prices to be paid has resulted in an overpricing of contractors to cover against price fluctuations, with significantly higher prices in comparison to other jurisdictions. The new principles will allow Pemex to agree on contracts that provide for price escalation formulas as a result of market fluctuations, changes in circumstances due to new information appearing with respect to the project, among other scenarios.

While Congress initially discussed the performance contracts model for exploration and production contracts, the reform did not limit its use to such projects, and has thus provided the possibility to use these schemes for other productive infrastructure projects, such as the construction of a refinery, pipelines and terminals, to name a few.

Contracts will be subject to Mexican law and be resolved in Mexican federal courts, but the law does allow for the possibility of submitting to international commercial arbitration with no restrictions as to the arbitration situs or applicable arbitration rules. This may

be expected to provide for more conducive agreements, with a lower risk profile from the risk assessment perspective. Note also that because Mexico is a party to all major commercial arbitration treaties (including the New York Convention for the Recognition and Enforcement of Foreign Arbitral Awards), any commercial arbitration award issued against Pemex would be fully valid and enforceable in Mexico through a federal court.

The level of the consideration payable to contractors under the new scheme will be left to the determination and discretion of Pemex, with the principle that it should be consistent with international industry practice. This discretion will be controlled, though, through considerable audit and surveillance to which Pemex will be subject, including (i) the registration of incentive-based contracts with the National Hydrocarbons Commission (*Comisión Nacional de Hidrocarburos*), (ii) the audit of the Audit and Performance Committee of the Pemex Board of Directors, (iii) surveillance by federal agencies and the Congress auditor.

## Contracting rules

One of the major hurdles that the petroleum industry has found for its growth has been the inflexible and archaic contracting system for the procurement of everything from a laptop computer to the long-term lease of an FPSO or a jack-up rig, or the contracting of storage services for a terminal. The current Law of Public Works and Related Services (*Ley de Obras Públicas y Servicios Relacionados con las Mismas*) and the Law of Acquisitions, Leases and Services of the Public Sector (*Ley de Adquisiciones, Arrendamientos y Servicios del Sector Público*) are general procurement statutes designed for the whole federal government for the purchase of any kind of goods and services. It cannot be expected to work, therefore, correctly for the specific nature of the oil and gas industry.

One of the most important steps forward in the energy reform is that Pemex will be removed from such statutes – with respect to the contracting of productive infrastructure – and the Board of Directors will be entitled to issue (i) the rules, terms and conditions for the bidding of the projects, and (ii) the terms and conditions for the relevant contracts that Pemex will sign. The virtue of this is not only that Pemex will be able to provide more adequate rules, but also that it will be able to issue differentiated

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principles in dealing with different activities, and also that it will have the leeway to change them as experience requires.

The rules will be submitted for approval to the Board by its Acquisitions Committee, which will be chaired by one of the independent board members.

## E&P regulatory bodies

With the successful experience of Norway and Brazil in mind, Mexico will replicate the scheme of a quasi-independent regulator for exploration and production: the National Hydrocarbons Commission (CNH). With five presidential appointees, the CNH will be entrusted with the determination from a technical perspective of the levels of production and restitution of reserves, the issuance of technical standards for E&P activities (the so-called Official Mexican Norms or NOMs), the optimisation of production and recovery levels through the use of adequate technology (for which it will approve the E&P projects), and the evaluation of operational efficiencies. Importantly also, the CNH will be in charge of all statistical information with respect to production levels, PPP reserves, production/reserves ratios, prospective resources, and geological data, among others, and will be in charge of supervising compliance of major E&P projects from a technical point of view.

In an economy where 35% of the federal budget comes from Pemex exploration and production activities, but where Pemex does not provide access to reliable data regarding these critical financial variables, its publication and handling by an independent agency may have a very positive impact on the evaluation of Pemex's performance and the optimisation of the use of its financial and technical resources. The CNH is to be installed within 90 days of promulgation and in operation within 180 days.

A National Energy Council (Consejo Nacional de Energía) will also be installed, with the authority to propose and design a national energy policy with the Ministry of Energy (*Secretaría de Energía*). This will be formed in 180 days, and as of 2010, the council will propose a strategy that the President will be required to submit to Congress for approval on a yearly basis. The national energy policy will have a 15-year horizon, which will be updated yearly by the National Energy Council, and subject to ratification by Congress in February of each year.

## Pemex overhaul

Pemex will continue to be 100% state-owned. However, major changes will be introduced which are expected to significantly enhance its project execution and its exploration and production capabilities, while reorienting its development towards value optimisation. Historically Pemex has been handled on the basis of political – not technical or financial – considerations.

Pemex will introduce a series of important corporate governance principles, namely:

1. Consistent with OECD principles, 25% of the members of the Board of Directors will be independent professional board members (to be proposed by the President and ratified by the Senate).
2. A series of committees will be formed (including Audit and Performance, The Compensation, Acquisitions, Transparency, Environment and Sustainable Development). Committees will be chaired by the professional board members with specific duties provided by law.
3. Board decisions shall be approved by a qualified majority, requiring the favourable vote of a majority of the professional members.
4. The Board will be given increased authority for the management of Pemex, particularly in the area of decision-making with respect to the contracting of foreign and domestic debt, the approval of investments, and the approval of a five-year business plan. Currently investment decisions and the approval for incurring debt are made by the Ministry of Finance (*Secretaría de Hacienda y Crédito Público*) and not by Pemex.

## Pemex to become 'Public'

While Pemex has been a major player in the debt markets in the US, Europe and elsewhere, it has never operated as a public company, inasmuch as it has never opened its financials, performance, programmes and plans and other typical disclosures to the scrutiny of the investor public. A major virtue of the reform is the creation of the so-called 'citizen bonds', which will be debt financial instruments to be traded in the market, and which will have a yield which will be linked to the actual performance of Pemex. While the most immediate benefit will be that Pemex will share with its 'constituents' (i.e. the Mexican people) a portion of its profit, treating them to some extent as shareholders

receiving dividends, the most important mid-term advantage will be that the market participants and the bond holders will create a force of their own and a market pressure for Pemex to live up to its performance expectations, abide by its business plan and in general act in accordance with its business purposes as a company, and not as a political tool.

Funds raised by Pemex through citizen bonds will be earmarked for investment in productive infrastructure that complies with certain return criteria.

## Renewable energy

Supplementing the reform on hydrocarbons exploration and production, Congress introduced a new statute to foster and regulate renewable energies and the financing of energy transition. The bill is expected to create incentives for the development of renewable energy projects, and is being seen as an important step forward. The Energy Regulatory Commission (*Comisión Reguladora de Energía*), which is the federal regulator dealing with midstream and downstream natural gas and with the reform, will also deal with midstream and downstream activities dealing with liquids and

petrochemicals. It will also allow the jurisdiction to set the rules for the dispatch of renewable energy power facilities, one of the major hurdles typically for these projects, which because of the reliability of their source of energy have higher costs of production and are thus, under traditional rules, dispatched in lower proportions. Likewise, the CRE will set the rates that CFE, the vertically integrated power monopoly, will pay to the renewable energy generators, which will include capacity charges as well as rates payable based on throughput. The Ministry of Energy will also have the mandate for increasing the amount of renewable energy projects built in the future in comparison to fossil-fueled plants.

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