

Energy Reform in Mexico

Secondary Legislation and Its Implementation

1. Background

On December 20, 2013, the Official Federal Gazette published a decree to reform and add various energy-related provisions to articles 25, 27, and 28 of the Political Constitution of the United Mexican States (the "**Constitutional Reform**"). Although the Constitutional Reform laid the foundations for the new energy regulatory framework, many of the central points were left subject to secondary legislation.

This secondary legislation was published on August 11, 2014, in the Official Federal Gazette, resulting in the enactment of nine laws and the amendment of 12 existing instruments. These reforms implemented important elements of the Constitutional Reform and introduced a number of significant changes to both the oil and gas and electricity industries.

2. Oil and gas industry

For this industry, the main changes introduced by the Constitutional Reform and implemented by secondary laws are: (i) a new structure of permits, assignments, and contracts, which will allow greater participation by the private sector in the activities of this industry; (ii) the innovative way in which the State will collect and manage oil and gas revenues; and (iii) how Petróleos Mexicanos (**Pemex**) will be treated as a State owned production enterprise (**EPE**).

2.1 *Opening up of the oil and gas industry*

In the past, most of the activities in the oil and gas industry were considered strategic areas reserved for the State. Following the reform, many of these areas are now free from this restriction and open to private sector participation.

Oil and gas exploration and extraction activities continue to be reserved for the State. According to the new Oil and Gas Law, the State will conduct these activities in two ways: (i) assignments (EPEs only) and (ii) contracts (including both EPEs and private parties).

All other activities in this industry will be subject to a permit system. Thus, the State will now allow direct involvement by private players in activities such as basic petrochemicals, as well as oil and gas transmission, storage and processing. To be able to carry on any of these activities, interested parties must have the necessary permits from the Energy Secretariat (**SENER**) or the Energy Regulatory Commission (**CRE**), according to the type of activity they seek to perform¹.

¹ Permits to perform activities related to the oil and gas industry issued before these reforms will remain valid. Permits for the sale of gasoline and diesel to the public will be issued by the Energy Regulatory Commission, effective January 1, 2016.

2.1.1 Assignments

Pemex, or any other EPE, may conduct oil and gas exploration and extraction in the areas for which they have been granted an assignment license by the Energy Secretariat. The favorable opinion of the National Hydrocarbons Commission² (**CNH**) will also be necessary.

Assignees may enter into service agreements with private parties for the operational implementation of activities related to such assignments, provided that the private party's consideration is paid in cash.

Pemex may, after receiving the required authorization from the Energy Secretariat, delegate awarded assignments by entering into agreements with private parties. If the EPE decides to partner with private parties for the performance of these contracts, the National Hydrocarbons Commission will launch a public tender, as described in subheading 2.1.2 below.

2.1.2 Contracts

Private parties, as well as EPEs, will be able to participate in exploration and production activities by entering into contracts with the National Hydrocarbons Commission. These contracts may only be concluded by companies that: (i) are resident in Mexico for tax purposes; (ii) are engaged exclusively in the exploration and extraction of oil and gas; and (iii) do not pay taxes under the so-called tax integration regime.

As a general rule, the contracts will be awarded by public tender and will be subject to the technical and financial guidelines issued by Energy Secretariat and the Secretariat of Finance and Public Credit (**SHCP**). Private parties or EPEs will be able to participate in these tender processes as individual entities, a consortium, or through silent participation agreements (*asociación en participación*).³⁴

Although an initiative from the executive branch of the government provided otherwise, the secondary legislation allows a company to be assigned multiple oil and gas exploration and extraction contracts simultaneously.

These contracts may be any of the following types:

- (i) *Licensing contracts*: the benefit for the contractor will be the option to acquire the extracted oil and gas for consideration, provided the contractor has no outstanding obligations with the State, including the signing bonus, the contractual fee for the exploratory phase, royalties and an amount of consideration based on the value of the extracted oil or gas;

² Under the so-called "round zero", Pemex was recently awarded multiple assignment licenses for various exploration areas and production fields.

³ The concept of a consortium appears for the first time, which, in Energy-related terms, will be construed as two or more EPEs or private companies submitting a joint bid in a tender for the award of a contract.

⁴ In the case of bids for contracts with the potential of finding a cross-border deposit, the bidding terms will require at least 20% participation by Pemex or another EPE in the project.

- (ii) *Licensing contracts*: the contractor receives a percentage of the profit made on the sale of the extracted oil or gas, and will be refunded for certain expenses and expenditure incurred. In exchange, the contractor must pay the State a contractual fee for the exploratory phase, royalties and an amount of consideration based on operating income;
- (iii) *Shared production contracts*: these contracts are drawn up basically with the same terms as profit-sharing agreements, with the difference that, instead of receiving a percentage of the profit in cash, the contractor is paid in kind, by receiving a percentage of the extracted oil or gas;
- (iv) *Service contracts*: the contractor provides oil and gas exploration and extraction services to the State, in exchange for an agreed amount of money.

All amounts of consideration payable to contractors will be paid by the State until the delivery of the oil and gas, without the option of advance payments. Whereas all amounts of consideration and other amounts payable to the State must be paid on the terms described in section 2.2 below.

2.2 Payment and management of oil and gas revenues

The Oil and Gas Revenue Law determines that the Mexican government will receive the following revenue from oil and gas exploration and extraction activities:

2.2.1 Fees

Assignees (i.e., Pemex or other EPEs) will pay an annual profit sharing fee, which is calculated at 65% of the value of the extracted oil and gas after subtracting certain allowed deductions.

The assignees will also have to make the following monthly payments for: (i) the right to extract oil and gas, calculated by extraction volume and (ii) the right to explore for oil and gas, calculated per square kilometer that is not in the production phase.

2.2.2 Consideration

The amounts of consideration that the contractors will have to pay to the State according to the type of contract (among those mentioned in 2.1.2 above) will be in respect of:

- (i) *Signing bonus*: this consideration must always be paid in cash. The amount and payment terms will be detailed in the bidding terms in each case.
- (ii) *Contractual fee for the exploratory phase*: this fee will be determined and paid monthly, and calculated according to the number of square kilometers that are not in production phase; a fee of \$1,150 for the first 60 months of the contract, or a fee of \$2,750 starting on the sixty-first month.

- (iii) *Royalties*: the royalties will be determined by reference to the contractual value of the oil and gas extracted under the contract and will also be paid monthly.⁵
- (iv) *Consideration based on the value of the oil and gas or operating income*: these monthly amounts of consideration will be determined by applying the percentage or rate provided in each contract to the contract value of the oil and gas or operating income, as applicable.⁶ Contracts *must include* adjustment mechanisms to account for monthly variations in oil and gas prices.

2.2.3 Tax on oil and gas exploration and extraction activities (**IEH**)

All contractors and assignees will be required to pay the IEH tax on a monthly basis, which is calculated per square kilometer covered under the contract or award document, at a fee of \$1,500 during the exploratory phase, or \$6,000 once the project is in the extraction phase. The revenues from this tax will go to the Fund for Oil and Gas Producing Municipalities and Federal Entities.

2.2.4 Income tax

The contractors and assignees will also have to pay any income tax due on any of the activities conducted under a contract or assignment.

Although they will be liable for income tax in accordance with the specific laws on income tax, the Oil and Gas Revenue Law provides certain tax benefits for contractors and assignees, such as the application of higher annual investment deduction rates and, in some cases, the ability to use losses over a longer period of tax years.

2.2.5 Mexican Oil Fund for Stabilization and Development (**FMP**)

The FMP was created as a public trust in which the Bank of Mexico will serve as trustee. The goal of the FMP will be to receive, manage, invest, and distribute the revenues from the assignments and contracts for the exploration and extraction of oil and gas.

2.3 National Control Center for Natural Gas (**CENAGAS**)

In view of the provisions set forth in the Constitutional Reform and the Oil and Gas Law, a decree was issued on August 28, 2014 for the creation of CENAGAS.⁷ This decentralized entity will serve as the national integrated natural gas transmission and storage system. In addition, CENAGAS will provide transmission and storage services using any infrastructure under its control.

⁵ The contractual value of each class of oil and gas will be determined in accordance with arithmetic formulas established by the Oil and Gas Revenue Law, which take into account any adjustments oil and gas prices undergo in the market.

⁶ The operating income will be calculated by subtracting from the contractual value of the oil and gas, the royalties paid by the Contractor and the cost recovery payments that the State refunds to the contractor.

⁷ A transitional provision has established that CENAGAS must have started operating by February 25, 2015.

A transitional provision determines that the pipeline transmission infrastructure for natural gas, owned by Pemex, as well as any reserve capacity contracts for the transmission and storage of natural gas, both owned by Pemex and the Federal Electricity Commission (**CFE**), will be transferred to CENAGAS.

CENAGAS will also be responsible for tendering strategic infrastructure projects for the proper integration of this system, on the terms determined by Energy Secretariat.

2.4 Pipeline classification

As recently explained by the Oil and Gas Undersecretariat, the gas pipelines on the national grid will be classed as strategic, financial and social, and each class will have its own tender structure.

Strategic pipelines are those that are essential to supply natural gas throughout the national territory, and will be built by private companies, following a public tender launched by CENAGAS. The State or a company will reserve capacity in exchange for a fee.

Financial gas pipelines are those that may be built independently by private companies for their own profit, subject to the required authorization by the Energy Regulatory Commission.

Lastly, social gas pipelines are projects which, although not financially attractive at the moment, may trigger economic development or improve supply in areas where natural gas is scarce (i.e., Chiapas, Oaxaca, and Guerrero). These pipelines will also be built following a public tender launched by CENAGAS, but will be financed by the government using funds from the federal expenditure budget.

3. Electricity Industry

As with the oil and gas industry, the new legislation allows greater participation by private players in the electricity industry. To this end, the Foreign Investment law was reformed, and the only activities now reserved for the State are planning and control of the national electricity grid, as well as public electricity transmission and distribution services.

These activities, as well as other new forms of private participation in this industry, will be governed by the new Electricity Industry Law (**LIE**), while the Federal Electricity Commission's involvement and special regime will be adjusted to its specific law.

3.1 Electricity generation

The Electricity Industry Law makes the option to generate electricity available to anyone who is interested in operating under a free competition regime, where power plants with capacity greater than or equal to 0.5 MW and power plants of any size with a generator on the wholesale electricity market will require authorization from the Energy Regulatory Commission. Those that do not require a permit, known as exempt generators, may sell their electricity and related products through a supplier.

3.1.1 *Transitional regime*

Regardless of their type, permits and contracts awarded or processed under the Public Electric Energy Service Law will continue to be governed by the terms set forth by this Law and all other provisions stemming from it. Owners may request to change these permits to single-purpose generation permits, in order to conduct their activities under the new Law.⁸

Holders of permits granted before the law will have the option to enter into a legacy interconnection contract, valid for up to 20 years, provided that before the Law enters into force, the interested party: i) had obtained or applied for a permit for a generation project and paid all applicable rights; ii) notifies his intention to continue with the project and proves compliance of certain requirements to the Energy Regulatory Commission, not later than December 31, 2016.⁹

Legacy interconnection contracts will be honored under the terms set forth in the Public Electric Energy Service Law until they expire.

3.2 **Electricity transmission and distribution**

The public electricity transmission and distribution service will be provided by carriers and distributors according to the general terms and conditions set forth by the Energy Regulatory Commission. Carriers and distributors are the entities or EPEs (i.e., the Federal Electricity Commission), or their subsidized production enterprises, responsible for the national transmission grid and the general distribution grids.

The private sector will be allowed some degree of participation in these activities, through partnerships or contracts (subject to tariff regulations and other conditions set forth by the Energy Regulatory Commission), under which companies will conduct on behalf of the government the financing, installing, managing, operating, and expanding of infrastructure needed to provide these services.

Carriers and distributors must interconnect their networks with any power plants or load centers requesting connections, whenever technically feasible and within the established timeframes, with the goal of ensuring open, nondiscriminatory access to these networks. Interconnection or connection contracts, respectively, must be based on the forms set forth by the Energy Regulatory Commission.¹⁰

⁸ Applicants requesting this change may request and obtain, for a period of five years after the change, reestablishment of the conditions of these permits and legacy interconnection contracts entered under such permits, as they appeared before the change.

⁹ Mainly, the holder must have agreed upon project financing, undertaken to purchase the main items of equipment, and paid out, for the purchase of fixed assets, a minimum of 30% of the total investment required for the project.

¹⁰ Whenever any of the work, extensions or modifications needed for the interconnection or connection are not included in the expansion programs for the national or general distribution grids, the generator, exempt generator, or end user may choose to perform them at their own expense or pay carriers or distributors to complete them.

3.3 Marketing

Marketing activities include: (i) providing supply to end users; (ii) representing the exempt generators on the wholesale electricity market; (iii) purchase/sale of electricity, financial transmission rights, clean energy certificates and/or any other services on this market; (iv) acquiring transmission and distribution services based on regulated tariffs; among others determined by the Energy Regulatory Commission.

In terms of supply operations, a distinction is made between suppliers providing basic services to anyone who requests them, under a tariff regulation structure (**basic service suppliers**), and those authorized to supply qualified users under free trade conditions (**qualified service suppliers**).¹¹ In either case, a supply contract must be in place before starting any type of services. Suppliers of last resort will provide service to qualified users who request the service.

3.4 National Energy Control Center (CENACE)

Like CENAGAS, CENACE was created by decree, published in the Official Federal Gazette on August 28, 2014, as a decentralized public agency of the federal government, with a legal personality and its own assets.

CENACE must ensure open access to the national and general transmission grids, and is also in charge of operational control of the national electricity system and the wholesale electricity market, on which generators, providers and qualified users may participate upon entering a market participant contract.¹²

3.5 Wholesale electricity market

The following purchase/sale transactions will be conducted on the wholesale electricity market: (i) electricity; (ii) related services; (iii) financial transmission rights; (iv) clean energy certificates; as well as other products, acting as a sort of clearinghouse to conduct electricity transactions.

Power plants (the generators) will offer to the wholesale electricity market all the available capacities to produce electricity, power and related services. The offers will be based on the costs incurred by these plants and controllable demand, which may be lower according to the terms set forth in the market rules.¹³ Power plants with restrictions on the total amount of power they can generate, in accordance with the program developed by the National Energy Control Center, must base their offers on the opportunity costs resulting from their programs.

Based on criteria for the safety of provision and economic efficiency, CENACE will determine the assignments and provision for the power plants, controllable demand, and import/export programs.

¹¹ Qualified users are those consuming a specific amount of electric power, and achieve this status by registering with the National Energy Control Center.

¹² The market rules will establish the minimum requirements to become a market participant, as well as their rights and obligations.

¹³ Controllable demand is the demand for electricity that end users offer to reduce, according to the market rules.

3.6 Clean energy obligations

The Energy Secretariat will implement the necessary mechanisms to enforce compliance with policies on energy source diversification, energy safety, and promoting clean energy sources. Moreover, obtaining clean energy certificates has become an obligation, for which the requirements will be established as a proportion of the total electricity consumed at the load centers.

The Energy Regulatory Commission will be the authority vested with the power to issue these certificates, and to establish any regulations on validating ownership and verifying compliance.

3.7 Geothermal energy

The Geothermal Energy Law was created to control geothermal power generation, with the goal of overseeing the recognition, exploration, and exploitation activities of geothermal resources by the private sector, the Federal Electricity Commission or EPEs, aimed at harvesting subsoil thermal energy in the national territory, whether to generate electric power or use it for other purposes.

Each activity or stage in the geothermal power generation process requires a different procedure, defined in the Geothermal Energy Law as follows:

- (i) *Recognition* is the activity from which it may be determined, through observation and exploration, whether a given area may be a source of geothermal resources. For this activity, the only requirement is to register with the Energy Secretariat, which will issue a permit valid for eight months. If the registered party wishes to apply for an exploration permit, their application must be filed with the Energy Secretariat two months before their recognition permit expires.
- (ii) *Exploration* is a set of activities aimed at confirming the presence of a geothermal resource and demarcating the geothermal area. A permit will be needed from the Energy Secretariat. These permits will be for an area measuring up to 150 km², and valid for a three-year term, which may be *extended* one time only, for a further three years, subject to certain requirements. A permit holder may apply for the concession within the six month period before the permit expiration date and up to six months after the permit has expired.¹⁴
- (iii) *Exploitation* includes activities for commercial purposes, which allow electricity and other resources to be obtained from subsurface heat, through well drilling or any other means.¹⁵ A concession granted by the Energy Secretariat will be required to conduct any exploitation activities, and will be awarded for an area equal to or smaller than the area covered by the exploration permit, valid for thirty years, which may be extended provided all the established conditions have been met, as well as all the requirements set forth in the Geothermal Energy Law and its regulations.

¹⁴ If a permit holder considers that the studies and information obtained at the exploratory stage or in a renewed permit term are sufficient to determine the presence of a geothermal resource to be exploited, that permit holder may apply to obtain the relevant concession from the Energy Secretariat, without needing to complete the term.

¹⁵ This includes all types of efforts needed for the construction, extraction, start of operations, production, and processing of geothermal resources for exploitation activities.

In accordance with the Geothermal Energy Law, the definition of “hydrothermal geothermal deposit” has been introduced in the National Water Law. It has also been established that any party interested in conducting exploration activities for geothermal purposes, must apply for a building permit for exploratory wells at the National Water Commission; while the exploitation, use and harvesting of groundwater contained in hydrothermal geothermal deposits will require a concession granted by this Commission with an authorization concerning environmental impact.

4. Legislation applicable to both industries

4.1 New regime on Pemex and the Federal Electricity Commission

In light of their new status as EPEs, Pemex and the Federal Electricity Commission will be subject to a special regime, owned entirely by the Federal Government.

As noted in the preamble, the goal of the new regime is to provide EPEs with a business structure that is independent, flexible and underpinned by best international corporate governance practices. The aim is thus to provide them with the necessary tools to compete with private companies, which will now have a more active role in both industries. It must be underlined that, under this legislation, EPEs will reap certain benefits (i.e., no profit sharing with their workers), which could give them an advantage over the private parties they are competing with.

Starting in fiscal year 2015, Pemex will pay taxes under the general tax regime for legal entities, as set forth in Title II of the Income Tax Law. This EPE will nevertheless retain a special tax regime in several respects.

Furthermore, Pemex’s existing subsidiaries may be retained and adopt the status of subsidiary production enterprises, or reorganize themselves to form one or more subsidiary production enterprises. Additionally, the Federal Electricity Commission will have the subsidiary and affiliate production enterprises needed to conduct its activities.

4.2 Coordinated regulatory entities on energy matters

Finally, the National Hydrocarbons Commission in the oil and gas industry, and the Energy Regulatory Commission in the electricity industry, will act as regulatory entities in charge of: (i) issuing, supervising, and monitoring compliance, and enforcing sanctions in cases of non-compliance in all matters under their authority, and (ii) issuing permits and authorizations.

The National Hydrocarbons Commission will also be responsible for public tenders and concluding contracts to carry out oil and gas exploration and extraction activities.

4.3 Implementation Timeline

According to announcements made by the federal government’s executive branch, the creation of a universal electricity service fund is expected for September 2014, as well as the anticipated creation of the Mexican Oil Fund for Stabilization and Development (FMP).

While the transitional articles in the secondary legislation set out longer terms for issuing the applicable regulations, various other federal agencies are expected to issue these applicable regulations by October 2014. Guidelines for the clean energy certificates will be published in this same month.

Programs with the initial clean energy requirements and the publication of the market rules are expected for early 2015, while the following should be published by the second half of 2015: i) Contract forms drafted by the Energy Regulatory Commission for the electricity market; ii) the national electricity system development program; and iii) the regulated distribution and service tariffs issued by the National Energy Control Center.

The official start of operations for the national electricity market is expected for December 2015, which is also the deadline for both Pemex and the Federal Electricity Commission to have completed their transition into EPEs.

Another important date is January 2017 when the price liberalization for liquefied petroleum gas is expected, with the delivery of gasoline sale contracts to the private sector starting one year later.

5. Conclusions

The onset of this energy legislation has made significant changes to the regulatory framework. It is especially important to consider the transitional regime that will apply to existing agents in both industries, as well as any opportunities arising for new investors.

In relation to these opportunities, it is extremely important for national and foreign investors to be aware of recent changes to the national legal system, so that they can implement the tax and legal strategy that best suits their specific needs, to adopt an efficient structure for their operations in Mexico.