

Mexico

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“Ch-ch-ch-ch-changes”

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1. Introduction

Mexico is currently implementing an unprecedented and extensive reform process. Until now, and following the 76-year-old state monopoly, which seemed to be carved in stone in the national Constitution, the few attempts that were made to change the legal framework of upstream activities, to allow private parties to participate, had amounted to limited legal changes that permitted private parties to enter into more flexible service contracts with *Petróleos Mexicanos* (PEMEX), the national oil company, which remained the sole operator within Mexico. Nonetheless, the performance of PEMEX with the last exploration and production contracts issued during the Felipe Calderón government was disappointing. The contractual areas, which comprised mature fields, and a rather large unconventional field called Chicontepec, did not add much to Mexico’s falling production and shrinking reserves.¹

By the time the government led by Enrique Peña Nieto of the Institutional Revolution Party took office in 2012, it was clear that reform was urgent. By then, US purchases of Mexican crude had decreased significantly² as a result of the booming shale oil extraction in the United States: by May–June 2012 US purchases had decreased by 30%.³ As a country with a strong dependence on oil revenues, a fall in exports meant less fiscal resources. That was a very important issue for the Peña government, which pursued a strong start based on solid public finances and a promise of economic growth.

Despite its visible and imminent necessity, the Mexican energy reform took many by surprise. Reform of Article 27 of the Constitution, which was enacted during the Mexican revolution and established that hydrocarbons are a national asset, was considered untouchable. Further, this article acquired greater historical and cultural meaning when it was amended by General Lázaro Cárdenas, following

1 See *Dictamen de las Comisiones Unidas de Puntos Constitucionales, Energía y Estudios Legislativos; primera, con proyecto de decreto por el que se reforman y adicionan los artículos 25, 27 y 28 de la Constitución Política de los Estados Unidos Mexicanos en Materia de Energía* at <http://comunicacion.senado.gob.mx/pdf/2013/dic/RefEne.pdf> (last accessed January 26 2015), pp8–11.

2 *Ibid.*

3 See Adrián Lajous, “*La Reforma Energética en México*”, *Nexos*, June 6 2014, available at www.nexos.com.mx/?p=21407 (last accessed January 26 2015).

the expropriation of the industry in 1938. This amendment prohibited the government from executing any concessions allowing private companies to participate in Mexican hydrocarbon exploration and production, although it allowed some contracts to be entered into with the Mexican government. After that, the Constitution followed a path that restricted private investment even more. In 1959, President Ruíz Cortines banned contracts and, from then onwards, only service companies remained in Mexico.

Since the onset of discussions of reform, there has been uncertainty about whether the president would take the great political risk of transforming 76 years of Mexican oil history. Rewriting Article 27 of the Constitution had been unthinkable to other governments. Other constitutional provisions that ensured state control over the hydrocarbons industry, such as Articles 25 and 28, could more easily be amended, but not the historically charged Article 27. However, to the surprise of many, the said article was included in the reform package presented before Congress in mid-December 2013. A complete overhaul of the Mexican legal framework, starting with the Constitution, was begun on December 11, 2013, setting a time record for the politically toughest legal reform in the history of Mexico. By the new year, and without significant political opposition and/or social unrest, both the Federal Congress and the great majority state legislatures had voted in favour of the constitutional reform, while the implementing legislation was approved and enacted during the month of August 2014 in what must be considered the most rapid and significant legal change in the course of Mexican history.

2. Hydrocarbon legal regime

2.1 Articles 25, 27 and 28 of the Constitution

The new hydrocarbon legal framework is composed of the Constitution, the implementing legislation and the forthcoming regulations. While Articles 25 and 28 establish the nature of the relationship between the government and the newly denominated 'state productive enterprises' as well as the principles for the new competitive hydrocarbon model, Article 27 maintained state title on the hydrocarbons in the subsoil, kept the prohibition from entering into concessions but, on the other hand, sets forth that the activities of exploration and extraction may be performed by state 'entitlements'⁴ or by way of contracts entered into with private parties. At all times, the ownership of the hydrocarbons in the subsoil remains with the nation.

Article 25 introduces a change in PEMEX and also in the foundations of the exclusivity of the state in hydrocarbon matters. Formerly, this article stated that 'strategic activities', which included petroleum and other hydrocarbons in accordance with Article 28,⁵ would be performed by the state-owned and state-

4 'Entitlements' is our translation of *Asignaciones Petroleras* which is the authorisation the government gives PEMEX to perform exploration and production in some areas. Entitlements may only be held by PEMEX or other state productive enterprises.

5 The former text of Article 28 of the Constitution stated that oil and all hydrocarbons were strategic activities, which, according to the current text of Article 25, are exclusive to the state.

controlled “decentralised organisations”, which included PEMEX among other entities. Such organisations undertook tasks ranging from profitable activities such as oil and gas, to functions that are mainly administrative, such as those performed by the Mexican Transparency Institute.⁶ For such reasons, during the deliberative process of the reform, it was decided that PEMEX could no longer fit into a scheme that was originally intended for government agencies, since it should be perceived and operated as a company with a commercial and therefore lucrative purpose.

Finally, Article 28 of the Constitution draws an end to the oil and gas monopoly by limiting the exclusivity of the state solely within the bounds of hydrocarbon exploration and extraction. Before the reform, it was established that activities concerning “petroleum and all hydrocarbons” were a so-called “strategic activity”, exclusive to the state. Today, Article 28 limits such exclusivity solely to hydrocarbon exploration and extraction, under the terms of Article 27, which permits the state to enter into exploration and production contracts. That is, although Article 28 states that exploration and extraction are exclusive to the state, the amendment to Article 27 sheds light on the limited scope of such exclusivity as the state is allowed to enter into contracts with private parties.

2.2 Secondary (implementing) legislation

The main implementing legislation concerning exploration and production comprises:

- the Hydrocarbons Law, which replaces the 1959 Regulatory Law of Article 27 of the Constitution in Petroleum Matters;
- the PEMEX Law;
- the Coordinated Regulatory Agencies Law; and
- the Hydrocarbon Fiscal Revenues Law.

The first law concerns the basic rules with reference to upstream, midstream and downstream activities; the second is the stepping stone towards converting PEMEX into a productive state enterprise; the third details the structure of the legal powers of the upstream and downstream regulatory authorities; and, finally, the fourth law establishes the fiscal terms to be included in the contracts and entitlements executed between the private parties and the state, or the latter with PEMEX, as the case may be. These new laws, together with around 20 other reformed codes, comprise the new legal framework of exploration and production in Mexico.

2.3 Regulatory bodies

The main agencies in charge of hydrocarbon regulation are the National Hydrocarbons Commission (CNH) for upstream activities and the Energy Regulatory Commission (CRE) for downstream activities. The Energy Secretariat (SENER) also participates in some important regulatory tasks. The first two bodies are now vested with legal personality and technical and managerial autonomy and will be able to dispose of the income derived from payments received as a result of the issuance and

6 This institute performs typically administrative activities such as providing public information to Mexican citizens.

administration of permits, entitlements, authorisations and contracts. As will be seen later in this section, there are yet other agencies involved in the oversight of upstream activities, such as the fiscal authorities, la Secretaría de Hacienda (SHCP), and the newly created Agencia Nacional de Seguridad Industrial y Protección al Medio Ambiente del Sector Hidrocarburos (ANSIPA), which oversees environmental and industrial security matters.

(a) *The Energy Secretariat*

The Energy Secretariat has historically performed the dual purpose of policymaker and regulatory agency.⁷ As policymaker, it dictates energy policy for the hydrocarbon sector, setting the strategies and targets for oil production in Mexico. Further, this agency also performs tasks that are of a technical nature, which are ordinarily performed by regulatory agencies in other parts of the world, such as Brazil and Colombia, including:

- selecting the areas that will remain under the exclusive control of PEMEX (entitlements), as a result of bidding round zero, with the technical assistance of the CNH;⁸
- selecting the areas that will remain as strategic reserves and the ones that will be offered in bid rounds; and
- designing the technical and commercial aspects of the exploration and production contracts, with the technical assistance of CNH and establishing the applicable model for each area, be it a licence, a production sharing agreement, a profit sharing agreement or a service contract.

(b) *The National Hydrocarbons Commission*

A significant part of the discussions on reform concerned the recreation of the regulatory agencies. As happened with legal recreations in other sectors such as the telecomms and antitrust sectors, the discussion of the institutional design for the energy sector was not devoid of an analysis of how to achieve strong regulatory institutions that could withstand the power of the still enormous state productive companies and now also private actors of all sizes.⁹ The Mexican energy sector already had an upstream regulatory authority, the CNH, which was created during the 2008 energy reforms in an attempt to regulate PEMEX's exploration and production activities. Further, since 1995 there has also been a downstream regulatory authority, which has been the enforcer of market-based pricing mechanisms and transport, distribution and storage tariff rates for natural gas.¹⁰

During the reform process it was agreed by the political parties promoting the reform that CNH needed to be strengthened with more autonomy, more important

7 All SENER's legal powers concerning exploration and production contracts are listed in Article 29 of the Hydrocarbons Law, published in the *Federal Official Gazette*, August 11 2014. See www.dof.gob.mx/nota_detalle.php?codigo=5355989&fecha=11/08/2014 (last accessed January 26 2015).

8 See the above-mentioned Article 29 of the Hydrocarbons Law, section 1.

9 See Miriam Grunstein "Ahí Viene el Dolor...", *Este País*, October 1 2013, available at <http://estepais.com/site/2013/ahi-viene-el-dolor/> (last accessed January 26 2015).

10 For more information regarding the downstream regulator, visit the CRE website at www.cre.gob.mx/ (last accessed January 26 2015).

legal powers and greater financial autonomy. As a result, CNH officers, although proposed by the president, must now be ratified by two-thirds of the Senate. Further, in order to shelter them from political pressures, they can be removed from office only due to causes established by the Hydrocarbons Law.¹¹ The commission will be a collegiate body of seven commissioners, with one chairman. Pursuant to the Hydrocarbons Law, CNH has some important legal powers, such as being in charge of the performance of the bid rounds for the exploration and production contracts, awarding such contracts and executing the same with the winning companies. Following contractual execution, CNH will perform the technical administration of the contracts.¹² Although CNH performs the bid rounds, awards the contracts and is in charge of their administration, it is not responsible for their design. The commercial and technical design of bid rounds is done by SENER, while the fiscal terms are established by the fiscal authority, the SHCP.¹³

It should be noted that the 2013 reform undertook an important change in terms of the parties involved in contractual execution. Before the reform, all contracts were executed by PEMEX, with SENER and CNH having no influence in such matters. Today, all exploration and production contracts will be entered into with CNH.

(c) ***The Agency for Industrial Safety and Environmental Protection***

The Mexican legal reform was responsive to the recent Deepwater Horizon catastrophe and thus created a specialised agency for industrial security and environmental protection. The agency is an administrative unit ascribed to the Environmental Secretariat and is in charge of monitoring upstream hydrocarbon activities and enforcing their compliance with safety and environmental regulation.

Pursuant to its law, the legal duties of ANSIPA comprise the following:¹⁴

- to issue and enforce the regulatory framework for environmental protection and industrial safety for the entire national hydrocarbon industry, in accordance with international best practices;
- to inspect oil and gas worksites and verify compliance with the said regulation by exploration and production operators;
- to assess and apply the penalties and security measures that may occur owing to the lack of compliance of the companies with the environmental and safety regulatory framework;
- to cooperate with the Environmental Secretariat and other agencies, so that the industry meets the highest standards of environmental protection and industrial safety; and
- to investigate the causes of workplace accidents and potential environmental catastrophes resulting from oil and gas exploration and extraction activities.

11 Article 31 of the Hydrocarbons Law establishes the legal powers vested in CNH in matters regarding exploration and production contracts.

12 See Articles 29 to 31 of the Hydrocarbons Law for the legal powers of each regulatory entity concerning exploration and production.

13 The legal powers concerning exploration and production contractual matters are set out in Article 30 of the Hydrocarbons Law.

14 See the ANSIPA Law 2014 at www.diputados.gob.mx/LeyesBiblio/pdf/LANSI_110814.pdf (last accessed January 26 2015).

(d) *The Mexican Petroleum Fund for Stabilisation and Development*

One of the great concerns voiced by the dominant political forces during the reform process concerned the administration of oil revenues. Mexico's heavy fiscal dependence on such revenues has impeded them from being reinvested in productive projects. For this reason, the reform created a fund that will receive all the proceeds from oil which are not taxes. This fund is entrusted to Mexico's Central Bank (Banco de México) which will be in charge of the receipt, administration and distribution of the revenues derived from the entitlements and contracts entered into by the state with companies. The revenues will be calculated after taxes. The fund will be managed by a technical committee composed of the Secretary of Energy, the Secretary of the Treasury and the Governor of the Central Bank with four independent members, who will be appointed by the president and ratified by the Senate. Further:

a priority chain has been designed to organize the fund's distribution. In the order of priority, debt sovereign payment and long-term savings. If the net income exceeds 0.15% of the GDP, an investment programme will be triggered for developments, projects and pensions among other things.¹⁵

(e) *The Energy Coordination Council*

Throughout the discussions on reform it became clear that one of the weakest points of Mexico's energy sector is a lack of consistency in its decision-making processes. This lack of consistency has stemmed mainly from a lack of coordination between the Energy Secretariat and the upstream (CNH) and downstream (CRE) regulatory authorities. Although problematic, this lack of coordination was tolerable in a sector that had been state controlled as there were not many stakeholders involved. But now, with the opening up of the industry, it is hoped that many more players will become a part of Mexico's petroleum industry, thereby posing new and more significant challenges for regulatory authorities. It is true that:

many of these institutions have little to no experience in running a bidding process or working with IOCs.... The effectiveness of this transition will fully depend on the expertise of the professionals leading these institutions and their capacity to learn from foreign failures and success stories.¹⁶

Hence, the new Coordination Council for the Energy Sector is chaired by the energy secretary and is composed of the undersecretaries of electricity and hydrocarbons, the commissioners of the regulatory agencies and the directors of the natural gas and electricity independent operators. The purpose of this council is to ensure consistency in the rulings of the regulators with energy policies to ensure the success of the reform. Within the context of the council, the energy secretary may give an opinion on those resolutions that are deemed to be contrary to energy policy; and, although the law does not make these opinions binding, the political weight of the secretary may have an important influence on regulatory activity. Hence, this

15 See David Enriquez, "Emerging Energy Paradigm", *Mexico. Oil and Gas Review*, 2014. New Energy Connection LLC, 2014, pp34-35.

16 *Ibid.*

council may indeed be conducive to more consistent regulatory activity, but it also may affect the autonomy of the Mexican regulatory agencies.

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