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CCN NEWS FLASH

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Mexico Passes New Energy Laws

Mexican President Enrique Peña Nieto used the National Palace (*Palacio Nacional*) in the heart of Mexico City as the setting for an historical event yesterday, as he signed six decrees creating nine new laws and significantly amending twelve existing laws, all of which form the new legal framework for Mexico's energy sector. The President also ordered the immediate publication of such decrees in an unusual evening edition of the Official Journal of the Federation.

History is Made

This is a truly transcendental reform. It has been 76 years since President Lázaro Cárdenas decreed the large-scale expropriation of petroleum industry property and assets that were primarily owned by U.S. and British companies. Thereafter, the 1960's brought the definitive closure of the Mexican energy sector as the electricity industry was nationalized and all hydrocarbons industrial transformation activities were incorporated into the state-owned monopoly.

In the 1990's, certain activities in the energy sector were opened to private participation. Twenty years later, it became clear that the state-controlled model in which the energy industry operated was in need of a paradigm shift. Thus, in December 2013 the Mexican Constitution was amended to establish the legal basis for a new free market model with state regulation. The next step was the issuance of laws to build the new industrial organization of the energy sector, establish the rights and obligations of its participants, and determine the regulatory authorities of the institutions in charge of overseeing competition, transparency, safety, and environmental protection in this sector.

A New Legal Framework

Three months after the President presented his bills to Mexico's Congress for debate and final consideration, the task of creating the details underpinning the new reforms has been completed. Legislative sessions held in the Mexican Senate and House of Representatives were marathon affairs, marked by passionate debate and tension among the participants. As expected, Mexico's leftist parties focused their agenda on defending national sovereignty, identifying such with the sub-surface mineral resources and even the government organisms *Petróleos Mexicanos* (Pemex) and the Federal Electricity Commission (*Comisión Federal de Electricidad*, CFE). In the end, broad majorities approved the new laws in both chambers of Congress. Nevertheless, the implementation of the reform must address legitimate concerns expressed during the legislative debate on issues such as the protection of human health and the environment, especially regarding unconventional production of hydrocarbons, and the fight against traditional corruption in this sector, particularly among its labor unions.

Ten Important Changes

The fundamental premise of the new Mexican energy regime is that it will afford private domestic and foreign investors necessary legal certainty to participate directly in activities previously reserved exclusively to the Mexican state. Below are ten key changes all businesspeople and professionals should bear in mind:

1. Exploration and production of oil and natural gas (including shale gas) may now be carried out through licensing agreements, shared production agreements, shared profit agreements or service agreements that will be granted pursuant to bid processes conducted by the National Hydrocarbons Commission (*Comisión Nacional de Hidrocarburos* or CNH), and through the occupation of land surface areas via negotiations with landowners who will be entitled to receive payments based on a percentage of profits received by producers. Those agreements will include a minimum percentage of Mexican participation, which will gradually grow from 25% in 2015 to 35% in 2025.
2. Oil refining and gas processing will be open to private investment through permits granted by the Department of Energy (*Secretaría de Energía* or SENER).
3. While transportation, storage and distribution of gas have been open to private investment since 1995, now it will be possible for private investors to participate in the transportation, storage and distribution of oil, petrochemicals, and refined products. For example, the Energy Regulatory Commission (*Comisión Reguladora de Energía* or CRE) will grant permits to transport such products through pipelines.

4. Beginning in 2016, the CRE will begin issuing permits for the establishment of independent gasoline and diesel service stations, without requiring a Pemex franchise. Starting in 2018, fuel prices will be determined by the market.
5. The generation and supply of electricity may now be carried out by individuals within the framework of a wholesale market operated by the National Center for Energy Control (*Centro Nacional de Control de Energía* or CENACE), a new agency independent from the CFE.
6. Although power transmission and distribution will remain public services entrusted to the CFE, private parties may participate in such activities by means of agreements and associations, and the fees for these services will be determined by technical criteria based on real costs, not economic or social policy considerations.
7. The CNH and the CRE will no longer be part of the SENER, but instead will become independent federal agencies with greater resources and better institutional guaranties as to their autonomy.
8. The new National Agency for Safety and the Environment in the Hydrocarbons Sector will be responsible for oversight of activities such as hydraulic fracturing (*fracking*) and deep-water exploration and production.
9. The National Center for Natural Gas and the CENACE, the former as owner of 90% of the country's existing transportation pipelines, and the latter as operator of the electricity system and market, will have the task of bringing about open access to the respective networks.
10. Pemex and the CFE will have greater flexibility as "productive state companies" and will no longer be decentralized entities governed by Mexico's executive branch; consequently, they will be required to adjust their corporate governance in accordance with international best practices.

Next Steps

These are just a few highlights of a reform that is extraordinary for its breadth and depth. What comes next? In the next several months, the President must issue the rulings and decrees that will provide the administrative procedures for enforcing the new energy laws. In fact, yesterday it was announced that the process for issuing presidential rulings will be accelerated and must conclude by October 2014. Meanwhile, regulatory agencies must begin to work on the design of the general administrative provisions that are needed to detail the manner in which they will conduct their regulatory functions. Also, issuance of the "green

package” mandated by the 2013 constitutional reform is pending and is expected to occur in December 2014; by means of it, the Mexican Congress will establish incentives to guarantee energy security on a long-term basis and to assure that energy sector participants entirely assume the environmental costs of their activities.

Yesterday, the President announced that the disclosure of the *Round Zero* resolution will also be expedited from the expected date of September 21, 2014 to tomorrow, when the SENER will announce which territorial areas (“blocks”) previously requested by Pemex will be granted to Pemex for exploration and production. Mexico’s executive branch has also announced that proceedings related to *Round One* will begin immediately, and it is expected that the areas for exploration and extraction agreements subject to *Round One* will also be disclosed tomorrow. Finally, it is expected that Pemex will announce what areas such state-controlled company desires to operate through associations with private parties.

With respect to energy, Mexico now has new world-class opportunities to offer investors. In this transition period, new participants in the Mexican energy industry must overcome the enormous market power that entities such as Pemex and the CFE will maintain, among other institutional inertia. Cacheaux, Cavazos & Newton (“CCN”) is equipped with the technical expertise and infrastructure in Mexico to assist its clients with energy projects in light of the new energy reform. CCN will monitor the forthcoming legislative and regulatory events relevant to the energy sector and will continue to provide timely information about future developments.

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