

PRIVATE SECTOR PARTICIPATION IN THE ENERGY SECTOR¹

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Among the structural reforms being undertaken in Mexico, the reform to the energy sector stands out, particularly as many questions arise as to the manner in which the private sector will participate. These will not be answered until the various regulatory laws provide in detail for the main aspects addressed by the constitutional reform published on December 20, 2013, which amended articles 25, 26 and 28 of the Mexican Constitution.¹ This reform is a great opportunity to attract private sector investment and know-how for the energy sector, which is a very dynamic and innovative one, this being necessary to face the challenges in the coming years. The Mexican Congress has to enact the regulatory laws as are necessary for proper implementation of the reform not later than April 21, 2014.

As to the new regime that will govern public contract awarding, it will be interesting to see how this new regime shall be made to harmonize with the country's present legal framework for PPPs which at present provides an alternative legal structure under which the private sector may offer services to the public sector or to final users by partial or full use of infrastructure provided by the public sector.

Consideration is given below to some of the main characteristics of the reform and its implications for the private sector.

Transformation of PEMEX and CFE

The decentralized entities *Petróleos Mexicanos* (PEMEX, the Mexican state oil company) and the *Comisión Federal de Electricidad* (CFE, the Mexican state electric utility company) shall become State Production Companies (*Empresas Productivas del Estado* or EPEs) not later than December 20, 2015.

The main corporate purpose of these companies will be that of creating economic value and contributing to increase the country's revenues. Their organization and corporate structure will have to adhere to best international practices, and they will have special regimes governing employee labor relations, procurement, leasing, services and public works as required to better and efficiently attain their corporate purposes.

The above mentioned transformation will involve making significant changes in the regimes applicable to government procurement, since it will be necessary to make these

¹ Translated from Spanish by Victoria Cisneros Stoianowski

more flexible and make innovative changes in, and modernize the regime governing the liability of public servants in a manner such that the decisions regarding the internal regime of these companies and their operations in the market resemble as closely as possible those currently prevailing for their private sector counterparts. This will surely imply a major change in the corporate structure of both companies, probably requiring their streamlining and the elimination of needless bureaucratic procedures which nowadays seriously hamper their operation, so as to enable their incorporation into a highly competitive market.ⁱⁱ

Assignations and contract awarding and execution

During the transitional process, PEMEX and its subsidiaries are authorized to receive “assignations” (concessions between public entities) from the Ministry of Energy (Spanish acronym: SENER) and enter into agreements with the federal government or else, to enter into agreements with the private sector for oil exploration and extraction.

Once PEMEX has been granted such assignations, which will constitute the original title allowing for the undertaking of the above mentioned activities, PEMEX may propose that these migrate to the contract regime and, if so, and PEMEX decides to operate with the private sector, contract awarding shall have to adhere to a public bidding process that will be conducted by the National Hydrocarbon Commission (Spanish acronym CNH).

For PEMEX to be assigned the activities for the exploration and extraction of oil and other oil products it will have to show that it has the technical, operational, financial and practical capabilities to undertake the relevant activities efficiently and that it is competitive. PEMEX must submit its request to the SENER not later than March 2014, for the latter to issue its resolution within a term of six months counted as of the date of filing.

As regards the CFE, it will be able to enter into contracts with private entities in all activities, including generation and marketing, that are different from electric power transmission and distribution.

As can be appreciated, once the transitional period has elapsed, both PEMEX and CFE will be able to enter into contracts with private sector entities regarding activities in which they are now allowed to participate: exploration and extraction, in the case of oil and oil products, and all the activities different from transmission and distribution, in the case of electric power.

Contracting and compensation schemes

The types of contracts that may be entered in order to undertake the exploration and extraction of oil and other oil products, whether solid, liquid, or gaseous, shall be: (i) service contracts, (ii) shared profit or shared production contracts; and (iii) license contracts *inter alia*, all of these in the understanding that title over all solid, liquid and gaseous hydrocarbons in the subsoil is reserved to and reside in the Mexican nation.

This is one of the issues that has given rise to debate among the parties interested in the sector, because several years will have to go by before it is possible to determine whether application of any of the above mentioned contracting schemes will contribute to increase

the nation's revenues, and this will in turn depend to a great extent on the agreements entered in each particular case.

Compensation to be paid by the state for such activities, either to its own EPEs or else, to private entities, shall take the form of, *inter alia*: payment in cash for service contracts, (ii) payment as a percentage of profits or of production under either shared profit or shared production contracts, as applicable; (iii) by onerous transfer of the oil or hydrocarbons once extracted from the soil for license contracts, or (iv) any combination of the foregoing.

It is important to mention that these shall not be the only compensation schemes and therefore it should be kept in mind that compensation may be subject to additional standard performance requirements as regards quality and timeliness, since this would foster participation in the undertaking of these activities by the best private sector companies.

Private sector project initiatives

One of the innovations introduced by the new Mexican PPP Law (*Ley de Asociaciones Público Privadas*) is that it provides for the possibility of private sector entities to submit by their own initiative a proposal for the undertaking of a project (an unsolicited proposal) to the appropriate authority for review, and should this entity find that the project is viable, it may proceed with a bidding process in which the entity will be afforded special treatment over the others with respect to its financial offer, this as provided in this statute, due to innovative nature of the project.

The foregoing will no doubt provide an incentive for private entities to detect and bring to the notice of the public sector opportunities which have not been identified by the latter or indeed which have not been undertaken due to the lack of resources, thus fostering and ensuring joint efforts of both sectors in the undertaking of new and a greater number of projects.

Coordinated Regulatory Entities for energy matters

The CNH and the Energy Regulatory Commission (*Comisión Reguladora de Energía*, Spanish acronym CRE), will now be the energy regulatory bodies. The former will act in an advisory capacity to the SENER in technical matters, and will also be responsible for gathering and providing geological and operational information to SENER, for conducting bidding processes and for the execution of contracts for the exploration and extraction of oil and oil related products.

The CRE will be responsible for regulating and granting permits for oil, gas, oil products and petrochemical products storage, carriage, conduction, and pipeline distribution, as well as for regulating the access of third parties to pipelines and facilities used to conduct and store oil and oil derivatives, as well as for regulating first-sale transactions of said products. As regards electric power, this public entity shall be responsible for regulating and granting permits for power generation, and regulating transmission and distribution rates.

Creation of the Mexican Oil Fund for Stability and Development

As a result of the reform, a public trust under the name of *Fondo Mexicano del Petróleo para la Estabilización y el Desarrollo* will be created in the course of 2014, which will be managed by the Mexican central bank acting as trustee. This fund shall start operating in 2015.

All income received by the State from assignments and contracts for exploration and extraction of oil and oil related products shall be received, managed and distributed from this fund, this not only to provide stability to the country, but also to ensure well directed growth. The fund's resources shall be used not only to settle any payments contemplated in the assignment agreements and contracts, but also to contribute to long-term savings, allocate funds for oil and oil product related research, energy sustainability and oil fiscal oversight, contribute to the country's federal expense budget, and in special cases, contribute to the universal pension fund, finance investment projects regarding renewable energy science, technology and innovation, the funding of a specialized investment vehicle for oil related projects and also to fund grants for the training of human resources at universities at for graduate studies and projects to improve connectivity and regional development of the industry.

The fund shall have a Technical Committee whose members shall be the Secretaries of Finance (who shall chair the Committee) and Energy, the Governor of the Mexican central bank and four independent members appointed by the President of the Republic with the approval of two thirds of the members present of the Senate.

Creation of the National Control Center for Natural Gas and the National Control Center for Energy

Both the National Control Center for Natural Gas (Spanish acronym CNCGN) and the National Control Center for Energy (Spanish acronym CNCE) will be public bodies that must be created within a term of twelve months as of the date the Regulatory Law of Constitutional Article 27 for the Oil Industry and as of the date the Regulatory Law for the Electric Power Industry enter, respectively, into force.

The CNCGN shall be responsible for the operation of the oil storage and pipeline conduction national network and the CNCE shall be responsible for exercising operational control over the national electric power system, for operating the wholesale power market, overseeing that there is open and non-discriminatory access to the national electric power transmission grid and to the general distribution networks, among others.

Creation of the National Industrial Safety and Environmental Protection Agency

The National Industrial Safety and Environmental Protection Agency shall be responsible for regulating and exercising oversight over the industrial and operational safety and environmental protection of all oil sector installations and activities.

Accounting reporting

Both EPEs that have been granted an assignation or have executed a contract with the State for exploration and extraction of oil and oil related products and the private entities entering into agreements with either the EPEs or directly with the State may report the respective assignation or contract for accounting purposes and the expected benefits, this constituting a tax regime that is halfway between that of some countries where the companies engaging in the exploration and extraction are considered to hold full title over the natural resources and others where there is blanket restriction on title.

General considerations

Sessions of the Mexican Congress that are just beginning this month of February shall see intense debate due to the large number of regulatory laws that need to be enacted, not only in regard to the oil sector but others that are especially sensitive, such as those for telecommunications. Once these have been enacted, we will be able to gain insight into the particular provisions that will govern private sector participation in the energy sector.

End of part one

ⁱ The constitutional reform entered into force on the day following its publication.

ⁱⁱ Article 10 of the Mexican PPP law, which entered into force in January 2012, establishes that the public-private partnerships schemes contemplated in this statute are optional and may be used in regard to activities whose specific laws contemplate free participation of the private sector.