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Analysis and Implications of the "Electricity Reform" Initiative for the Hydrocarbons Sector in Mexico

While the potential impacts and changes that the *Initiative with the Decree amending Articles 25, 27 and 28 of the Political Constitution of the United Mexican States* (the "**Bill**") sent by President Andrés Manuel López Obrador to the Chamber of Deputies on September 30, 2021[1] represent for the electricity industry have been extensively reported, the possible risks and impacts for the hydrocarbons industry have not been so clear.

In this document we analyze the proposed changes to the Constitutional text regarding hydrocarbons as proposed by the Bill, as well as the possible indirect impacts that may occur by virtue of the changes "strictly" focused on the electricity sector.

EXECUTIVE SUMMARY

The possible impacts of the Bill on the legal regime of the hydrocarbons industry are not so clear or evident from a simple reading of the text of the Bill. However, from a comprehensive reading of the amendments introduced to the Hydrocarbons Law (published on May 4, 2021) and other regulation issued by the current federal administration (*e.g.*, the Order regulating the import of Hydrocarbons and Refined Products issued by the Ministry of Energy ("**SENER**" on December 2020) or left without effect over the course of recent months, we identified risks that may affect the exploration and extraction of hydrocarbons, as well as the activities included in Third Title of the Hydrocarbons Law.[2]. In this document we mention these possible risks so that the regulated parties or industry participants can anticipate and make timely decisions in the event that such impacts actually occur.

In the Bill, for the first time, principles such as "*energy security and self-sufficiency*" are proposed to be added to the text of the Constitution. Given that such principles are and will likely be used as justification and legal basis for many of the actions taken by the current government against private parties in the hydrocarbons sector, the adoption of such principles at the Constitutional level will potentially serve as a basis for the Judges and Courts to deny

[1] You may find the original text of the Bill in the following link: http://gaceta.diputados.gob.mx/PDF/65/2021/oct/20211001-I.pdf

[2] For example, the marketing, import, export, transportation, storage, distribution and retail sales to the public of hydrocarbons, petroleum products and petrochemicals.

suspensions or otherwise not granting *amparo* protections against possible acts of authority of the SENER or the Regulatory Bodies (as such term is defined below). In addition, these may be used to justify denials of permit applications, such as export and import permits.

The above concepts or principles may be used by the Mexican Congress as a Constitutional mandate to make important modifications to the current hydrocarbons legal regime in order to restrict or affect the activities currently carried out by the private sector. In other words, it is important to understand that, subject to the limitation that the Constitution itself or the relevant international treaties may sanction, should the Bill be passed in the current terms, nothing precludes or limits Congress from amending the Hydrocarbons Law or other federal laws of the sector, notwithstanding the fact that the Bill was sold or announced as an "electric reform". To the same extent that the Mexican Congress may determine that the transitory provisions of the 2013 Energy Reform are in opposition to the Bill, it may result in the repeal of such provisions.[3]

On the other hand, the Bill includes novel and quite broad concepts such as "Energy Transition", which, among others, empowers the Comisión Federal de Electricidad ("**CFE**") to exploit (*aprovechar*) and use any natural resource or property in Mexico to such end. Given the role of natural gas in global energy transition, this may have an effect on the activities related to natural gas in Mexico and the possibility that the CFE may exercise rights or regulation in the subject matter under the Energy Transition argument.

The change in the legal nature of Petróleos Mexicanos ("**Pemex**") and CFE from State productive enterprises to "State instrumentalities" has or may have various impacts on the legal acts/contracts already entered into and the possible exercise of rights under such legal acts in the future.

The proposal to disappear the Regulatory Bodies should consider aspects that today are contemplated in the transitory provisions of the 2013 Energy Reform. The text of the Bill seems to leave them to secondary legislation or omit them altogether. In addition, the transition and disappearance of such Regulatory Bodies could have significant impacts on the approval and regulation times currently exercised by such bodies.

For all of the above reasons, Section 3 *infra* includes a series of recommendations and/or improvements to the text of the Decree contained in the Bill in matters of hydrocarbons.

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[3] The Eighth Transitory Provision of the draft Decree included in the Bill establishes that: "*all provisions in opposition to the content of this Decree are hereby repealed.*"

1. AMENDMENTS TO THE CONSTITUTIONAL TEXT.

1.1. Article 25 of the CPEUM.

1.1.1. Fifth paragraph.

In the section "*Contents of the Decree Initiative*"[4] of the Bill there is no mention as to the elimination of the last two sentences of the current fifth paragraph of article 25 of the Political Constitution of the United Mexican States ("**CPEUM**" or the "**Constitution**"), which is actually amended (eliminated) in the text of the draft Decree.[5] According to the text of the draft Decree, such paragraph would read as follows:

> The public sector will be, exclusively, in charge of the strategic areas indicated in article 28, paragraph fourth of the Constitution, maintaining always the Federal Government ownership and control over the State ~~productive enterprises~~ instrumentalities and the decentralized agencies ~~companies~~ that are established, as the case may be. ~~With respect to the planning and control of the national electric system and the public service of transmission and distribution of electric energy, as well as the exploration and extraction of petroleum and other hydrocarbons, the Nation will carry out said activities in terms of the provisions of the sixth and seventh paragraphs of article 27 of this Constitution. In the aforementioned activities the law will establish the rules relating to the administration, organization, operation, contracting procedures and other legal acts entered into by the State productive enterprises, as well as the compensation regime for their personnel, in order to ensure their efficiency, honesty, productivity, transparency and accountability, in accordance with the law, and shall determine the other activities that they may carry out.~~

Although this paragraph eliminates the express reference to the exploration and extraction of crude oil and other hydrocarbons, activities that according to the current text of the CEPUM will be carried out by the Nation in "*terms of the provisions of the sixth and seventh paragraphs of article 27*"[6] of the CEPUM, the fact is that the seventh paragraph of

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[4] *See* page 25 of the Bill.

[5] *See* page 29 of the Bill.

[6] The seventh paragraph of article 27 of the CPEUM in force as of the date hereof establishes:

> "*Dealing with petroleum and solid, liquid or gaseous hydrocarbons, in the subsoil, the property of the Nation is inalienable and imprescriptible and no concessions will be granted. In order to obtain income for the State that will contribute to the long-term development of the Nation, it will carry out the activities of exploration and extraction of petroleum and other hydrocarbons*

article 27 of the Constitution (which would become the eighth paragraph if the Bill is approved in the proposed terms) does not suffer substantial changes regarding the way in which the exploration and extraction activities will be carried out. For this reason, we do not conclude that the elimination of the last two sentences of the fifth paragraph of article 25 of the Constitution would affect the legal framework applicable to hydrocarbon exploration and extraction activities.

Now, with respect to the State productive enterprises (Pemex and CFE), the proposed amendments to the fifth paragraph of article 25 of the Constitution eliminate the "flexibility" of Congress to establish, through federal laws, the special nature of the State productive enterprises ("**EPEs**") with respect to their organization, operation, contracting procedures and other legal acts, as well as the personnel compensation regime. More importantly, today Congress and the Federal Executive Branch have the express Constitutional power to establish such rules and laws taking into consideration "the best practices".

By eliminating the flexibility provided to the EPEs by the fifth paragraph of article 25 of the CPEUM, the consequence will be that Pemex and CFE shall be treated like any other public instrumentality/agency or entity of the Federal Public Administration. In other words, this could go as far as to determine that, once again,[7] the contracting and procurement procedures of Pemex and CFE will have (or should have) to be governed by the Law of Public Works and Related Services and the Law of Acquisitions, Leases and Services of the Public Sector.

In the case of the CFE, however, the Bill itself provides for an exception regime for the CFE's purchases of electric energy. This Constitutional exception made for purchases of electricity results in the fact that all other acts (i.e., procurement and contracting) shall be regulated like in the case of any other instrumentality or entity of the Federal Public Administration.

In Section 1.2.3 *infra* we dive into other possible impacts of the Bill on the EPEs (particularly Pemex) by virtue of the change of its legal nature.

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through entitlements to State productive enterprises or through contracts with them or with private parties, under the terms of the Regulatory Law. In order to comply with the purpose of such entitlements or contracts, the State productive enterprises may contract with private parties. In any case, the hydrocarbons in the subsoil are property of the Nation and it must be so stated in the entitlements or contracts."

[7] Prior to the 2008 and 2013 Constitutional reforms in oil and energy matters, respectively, Pemex's contracting procedures was governed by the Public Works and Related Services Law and the Public Sector Procurement, Leasing and Services Law.

1.1.2. New seventh paragraph.

The Bill proposes to add a new seventh paragraph to article 25 of the Constitution, and the rest of the paragraphs will follow in the same order. According to the text of the draft Decree, such paragraph would read as follows:

> *The State shall preserve the energy security and self-sufficiency of the Nation, and the continuous supply of electricity to the entire population as an indispensable condition to guarantee national security and the human right to a dignified life.*

Although from a first reading it may be thought or concluded that the paragraph only establishes an obligation for the State to supply electric energy to the entire population on a continuous basis, we should point out that in this paragraph, for the first time, concepts that did not exist in the Constitutional text are added. Such is the case of the Nation's energy security and self-sufficiency.

The addition of this paragraph has effects not only in the electricity sector, but it may also affect other sectors. Since the current federal administration began to amend the regulatory and legal framework of the energy sector, the banner of such administration has been the same: *energy security and self-sufficiency of the Nation* or some variation of such concepts. In this sense, the addition of the new seventh paragraph elevates such "banner" to Constitutional rank.

This is interesting (perhaps worrying?) in light of the following amendments to federal laws, agreements and other provisions issued by the Federal Public Administration as of 2019:

(i) Article 59 Bis of the Hydrocarbons Law.[8] As a prerequisite for the application of the suspension of a permit (concept added by the amendment to the Hydrocarbons Law of May 4, 2021), SENER or the Energy Regulatory Commission ("**CRE**") must foresee an "*imminent danger to national security, energy security or the national economy*".

[8] Article added to the Hydrocarbons Law as part of the Decree amending and adding several provisions of the Hydrocarbons Law, published in the Federal Register on May 4, 2021.

Although the figure of "temporary occupation" originally provided for in Article 58 of the Hydrocarbons Law already included the foreseeable imminent danger to national security, energy security or the national economy as fundamental assumptions to exercise it, the truth is that the suspension concept allows the authority to order the permit holder to cease its activities completely while the suspension lasts, in addition to the fact that in the case of temporary occupation, reference is made to the assumptions provided for in the Expropriation Law.[9]

(ii) SENER Import and Export Order.[10] Article 28 of this Order establishes that the activities of SENER regarding the granting and supervision of prior permits for the import and export of Refined Products and Hydrocarbons will be "oriented based on the objectives of the public policy in energy matters, including those of energy security of the country". Likewise, article 28 of the Order establishes that SENER must consider *the* "*balance between the supply corresponding to national production and imports*", taking into account the country's energy security.

In addition to the above, other provisions[11] of the Order establish as a sufficient reason to deny or reject a prior permit when the analysis of the energy balance identifies an "*effect on energy security or the guarantee of fuel supply in the national territory*".

While the effects and consequences of the aforementioned laws and orders are suspended by virtue of several suspensions granted by various federal courts,[12] given the recent criteria of the Collegiate Circuit Courts, it is possible that both the amendments to the

[9] From the text of the second paragraph of article 58 of the Hydrocarbons Law, the events of the Expropriation Law are not always applicable or necessary for the "temporary occupation" to apply, since there are actually three events: (**i**) the assumptions set forth in the Expropriation Law; (**ii**) whenever the Permit Holder fails to comply with its obligations for causes not attributable to it; or (**iii**) when an imminent danger to national security, energy security or to the national economy is foreseen.

[10] *ORDER that establishes the goods whose import and export is subject to regulation by the Ministry of Energy*, published in the Federal Register on December 26, 2020.

[11] *See* article 46 of the Order.

[12] *See*: https://campaymendoza.com/recursos/jueces-federales-suspenden-reforma-a-la-ley-de-hidrocarburos-permisos/

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Hydrocarbons Law published on May 4, 2021, and the new Order that establishes the goods whose import and export is subject to regulation by the Ministry of Energy may enter into force in the short term. If so, the elevation to Constitutional rank of the concept of "energy security and self-sufficiency" may represent greater obstacles for private parties who have filed or will file legal appeals (*amparos*) against such laws and provisions.

1.2. Article 27 of the CPEUM.

1.2.1. Sixth paragraph.

The sixth paragraph of article 27 of the Constitution introduces the concept of "Energy Transition" as a reason for not granting concessions for the exploitation of lithium and other minerals considered "strategic" for the Energy Transition. In addition: (**a**) it "re considers" electricity as an exclusive strategic area for the Nation; and (**b**) it establishes the scope of the reservation or exclusivity of activities within electricity, including the generation, conduction, transformation, distribution and supply thereof. However, it also establishes that the Nation will take advantage of the property and natural resources required for such purposes.

If the Bill is approved, it would be written as follows:

> In the cases referred in the two preceding paragraphs, the ownership of the Nation is inalienable and imprescriptible, and the exploitation, use or exploitation of the resources in question, by private parties or by companies incorporated under Mexican law, may not be carried out except by means of concessions granted by the Federal Executive Branch, in accordance with the rules and conditions established by the laws, except in the case of broadcasting and telecommunications, which will be granted by the Federal Telecommunications Institute. The legal rules related to the works or works for the exploitation of minerals and substances referred to in the fourth paragraph, will regulate the execution and verification of those that are carried out or must be carried out as of their effective date, independently of the date of granting the concessions, and their non-observance shall give rise to the cancellation thereof. The Federal Government has the power to establish national reserves and to suppress them. The corresponding declarations will be made by the Executive in the cases and conditions that the laws foresee. In the case of radioactive minerals, lithium and other minerals considered strategic for the Energy Transition no concessions will be granted. The Nation is exclusively responsible for the strategic area of electricity consisting of generation, conduction, transformation, distribution and supply of electric energy. The Nation will exploit the property and natural resources required for such purposes. ~~the planning and control of the national electric system, as well as the public service of transmission and distribution of electric energy, in these activities no concessions shall be granted, without prejudice to the fact that the State may enter into contracts with private parties under the terms established by law, which shall determine the manner in which private parties may participate in other activities of the electricity industry.~~

As in the case of article 25 of the CPEUM (*see* Section 1.1 *supra*), the Bill seems to be limited to electric energy, however, it also establishes the prohibition of concessions for the exploitation of lithium and other minerals considered strategic.

First, since the State (through the CFE) will be in charge of the Energy Transition, it potentially will be the CFE itself who will determine the minerals it considers strategic to carry out such Energy Transition. This could mean that other minerals such as copper, zinc, aluminum or any others could qualify for not being granted concessions for the exploitation of such minerals at any given time.

Second, and in our opinion more worrisome, is the scope granted to the Nation to take advantage of the property (*bienes*) and natural resources "*required for such purposes*". These purposes understood as the Energy Transition. In this sense, all natural resources -including crude oil and natural gas- could be subject to such exploitation.

As it is widely known, natural gas has a very important -crucial- role in the energy transition to clean sources of energy for the generation of electricity. The broadness of the Constitutional text that is intended to be added to article 27 of the CPEUM could potentially open the door for the State to begin expropriation actions or to affect one or all of the activities of production, storage, transportation, distribution and commercialization of natural gas with the -Constitutional- argument that such natural resource and property (*e.g.*, transportation pipelines) should be used by the Nation through the CFE.

The foregoing can potentially be related to the amendments to the Hydrocarbons Law (mentioned in Section 1.1.2 *supra*) that allow SENER and CRE to suspend permits on energy security or national security grounds.

1.2.2. New seventh paragraph.

With the addition of the new seventh paragraph to Article 27 of the Constitution, the intention is to regulate the concept of Energy Transition. Said paragraph establishes:

> *The State is in charge of the Energy Transition and will use in a sustainable manner all energy sources available to the Nation, in order to reduce emissions of greenhouse gases and components for which it will establish the scientific, technological and industrial policies necessary for the transition, driven by financing and national demand as levers of development.*

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As in the sixth paragraph of article 27 of the Constitution to be amended, the new seventh paragraph establishes that the State (through the Federal Executive Branch or through the CFE itself) will use in a sustainable manner <u>all energy sources</u> available to the Nation, in order to reduce emissions of greenhouse gases and components.

By not establishing a clear and defined concept of "Energy Transition", it may imply a preferential use by the State of all natural resources available in Mexico, including natural gas.

Since it can be considered that the "use" by the State of thermal power plants whose base fuel is natural gas helps to reduce the use of other thermal power plants with more polluting technologies (*e.g.*, coal or fuel oil), the existence of combined cycle power plants or other cleaner technologies runs the risk of being subject to expropriation or which use is excessively regulated under the argumentation of "Energy Transition".

Although at this moment it is difficult to define or anticipate what the secondary legislation could foresee with respect to said "Energy Transition" that remains in charge of the State, it is certain that such concept opens the door for the CFE or other Mexican State agencies to undertake all kinds of actions that affect existing investments in different sectors, including minerals other than lithium, as well as natural gas, since they are considered natural resources "necessary" for such transition.

1.2.3. <u>Current seventh paragraph</u>.

In this case, the changes are limited to modifying the reference to Pemex and CFE as "*State instrumentalities*" instead of State productive enterprises. This amendment is the result of to the changes made to article 25 of the Constitution (*see* Section 1.1.1 *supra*); however, in this Section 1.2.3 we analyze in greater detail the significance and impact of the transformation of Pemex and CFE into "State instrumentalities".

The proposed amendment would read as follows:

> *In the case of petroleum and solid, liquid or gaseous hydrocarbons in the subsoil, the property of the Nation is inalienable and imprescriptible, and no concessions will be granted. For the purpose of obtaining income for the State that will contribute to the long-term development of the Nation, it will carry out the activities of exploration and extraction of petroleum and other hydrocarbons by means of entitlements to <u>State instrumentalities</u> ~~State productive enterprises~~ or through contracts with them or with private parties, in the terms of the Regulatory Law. In order to comply with the purpose of such entitlements or contracts, ~~State productive enterprises~~ <u>State instrumentalities</u> may contract with private parties. In any case, the hydrocarbons in the subsoil are property of the Nation and this must be stated in the entitlements or contracts.*

Regarding Pemex, it should be noted that the current Law of Petróleos Mexicanos[13] is based as a regulatory law of article 25 of the CPEUM as well as the Twentieth Transitory Provision of the Energy Reform of 2013.[14] In this sense, pursuant to section III of the aforementioned Transitory Provision, articles 6 and 7 of the Law of Petróleos Mexicanos establish that: (**a**) Pemex may carry out its activities by itself; with the support of its subsidiary productive enterprises and affiliated companies, or "*by entering into contracts, agreements, alliances or associations or any legal act, with individuals or legal entities of the public, private or social, national or international sectors (...)*"; and (**b**) that the contracts and, in general, all legal acts entered into by Pemex for the fulfillment of its purpose may "*include any of the terms permitted by commercial and common legislation (...)*".

Subject to what the Congress of the Union may decide regarding the legal nature of the "*State instrumentalities*" contemplated in the Bill, with the amendments to the CPEUM, the special legal regime of the EPEs that as of today provides legal and asset flexibility to Pemex to enter into all kinds of contracts and agreements with private parties is put at risk (or rather, cancelled). An example of this is the Joint Operating Agreements derived from association or migration of entitlements processes in which Pemex (specifically Pemex Exploración y Producción) accepts contractual terms such as the possible sale of participating interest in case of default with its obligations under the relevant Joint Operating Agreement, which effectively translates into a disposal of Pemex's property (more strictly speaking, rights) in an oil and gas field.

On the other hand, the provisions on property of Pemex must be considered. Pursuant to article 87 of the Petróleos Mexicanos Law, all acts relating to the disposal, use and enjoyment of Pemex's property are governed by common law. By abandoning its legal nature as a State productive enterprise, it is possible that such assets/property will once again be governed by laws applicable to the Federal Public Administration or new legislation that is more restrictive than the Law of Petróleos Mexicanos in the subject matter. This could have

[13] *See*: http://www.diputados.gob.mx/LeyesBiblio/pdf/LPM_110814.pdf

[14] Among other things, the Twentieth Transitory Provision of the *DECREE amending and adding provisions of the Political Constitution of the United Mexican States, in Energy Matters* establishes that the legal framework to be established by the Congress of the Union should establish, at least: (**a**) the creation of economic value and increase the Nation's revenue (Section I); (**b**) that their organization, administration and corporate structure be in accordance "*with the best international practices of the industry*", ensuring their technical and management autonomy, as well as a special contracting regime for obtaining the best results from their activities (Section III); and (**c**) that they have a special regime in matters of procurement, leases, services and public works, budgetary, public debt, administrative responsibilities and others (Section VI).

an effect on the guarantees (security) or rights that any individual may have over assets and rights of Pemex and its subsidiary productive companies.

In addition to the foregoing, it should be considered that this change or transformation may even have effects with respect to sovereign immunity of Pemex and it's, up to today, State subsidiary enterprises.[15]

Therefore, the elimination of the legal nature of the EPEs not only has a formal and administrative law enforcement element over Pemex but could also have negative effects on all contracts entered into under its special contracting regime provided by the Law of Petróleos Mexicanos under the cloak of the 2013 Energy Reform and more specifically the Twentieth Transitory Provision of such Decree.

It is important that persons and companies who have entered into this type of arrangements and contracts analyze whether the originally agreed contractual provisions could contravene public policy provisions at the time of enforcing them should the Bill be successful in the terms proposed.

1.3. Article 28 of the CPEUM.

1.3.1. Fourth paragraph.

The amendments to the fourth paragraph of article 28 of the Constitution reinforce what has already been established (or modified) in article 27 of the Constitution in the sense that the concept of "Energy Transition" gives a blank check to the Mexican State to determine that certain industries, natural resources (*e.g.*, lithium) and property may be considered as strategic or necessary to carry out or execute the Energy Transition. In the case of the amendments to the fourth paragraph of article 28 of the CPEUM, it goes a little further by establishing that the "*industries required for the Energy Transition*" are priority areas for national development in terms of article 25 of the CPEUM.[16]

If the Bill is approved, the fourth paragraph of article 28 of the CPEUM would read as follows:

[15] The Joint Operating Agreements used in the bid processes conducted by the CNH to award the farmouts with Pemex establish express waivers of any right to sovereign immunity to the greatest extent possible allowed by applicable laws.
[16] It is worth remembering that the Bill proposes to add to article 25 of the CEPUM, among other things, the obligation of the State to preserve "***the energy security and self-sufficiency of the Nation***". [Emphasis added.]

> The functions exercised exclusively by the State in the following strategic areas shall not constitute monopolies: post, telegraph and radiotelegraphy; radioactive minerals, lithium and other strategic minerals, ~~and~~ nuclear power generation, electricity;~~ planning and control of the national electric power system, as well as the public service of electric power transmission and distribution of electric energy~~ and the exploration and extraction of petroleum and other hydrocarbons, in terms of the sixth and eighth ~~seventh~~ paragraphs of article 27 of this Constitution, respectively; as well as the activities expressly indicated in the laws issued by the Congress of the Union. Satellite communication, ~~and~~ railroads and the industries required for the Energy Transition are priority areas for national development under the terms of article 25 of this Constitution~~;~~. ~~the~~ The State shall exercise its leadership in them, protect the security and sovereignty of the Nation, and when granting concessions or permits of the communication routes it will maintain ~~or establish~~ the domain ~~of the respective communication routes~~ in accordance with the laws of the subject matter.

As with the changes to article 27 of the CPEUM regarding the Energy Transition, the amendments to the fourth paragraph are broad and unclear as to the possible scope of powers and rights granted to the State (through the CFE, according to the sixth paragraph proposed to be added to article 28 of the Constitution discussed below).

Here we repeat the possible risk we see that the industry of import, storage, transportation, commercialization, distribution or other activities other than the exploration and extraction[17] of natural gas could be determined as a priority area or a necessary or strategic natural resource for the Energy Transition and therefore subject to restrictive treatment by the CFE or even subject to an expropriation procedure.

[17] Because **exploration and extraction** of hydrocarbons will continue to be considered (or remain as) a "strategic" activity or area in terms of the eighth paragraph of article 27 of the Constitution, which establishes (if the Bill is approved): "*In the case of petroleum and solid, liquid or gaseous hydrocarbons in the subsoil, the property of the Nation is inalienable and imprescriptible and no concessions will be granted. In order to obtain income for the State that will contribute to the long-term development of the Nation, it will carry out the activities of exploration and extraction of petroleum and other hydrocarbons through entitlements to State instrumentalities or through contracts with them or with private parties, under the terms of the Regulatory Law. In order to comply with the purpose of such entitlements or contracts, the State instrumentalities may contract with private parties. In any case, the hydrocarbons in the subsoil are property of the Nation and this must be stated in the entitlements or contracts*", we consider that the figure of contracts for the exploration and extraction would prevail over any figure that would be imposed due to or because of the Energy Transition or the determination of priority areas in terms of the fourth paragraph of article 28 of the CPEUM that the Bill intends to amend.

1.3.2. Sixth paragraph (new).

If the Bill is approved, the new sixth paragraph of article 28 of the CPEUM would establish the following:

> *The Federal Electricity Commission, a State instrumentality with its own legal capacity and property, is responsible for electricity and the National Electric System, as well as its planning and control; it will be autonomous in the exercise of its functions and its administration and will be in charge of the execution of the Energy Transition in electricity, as well as the activities necessary to such end.*

Although this paragraph establishes that it will be the CFE who will exercise the rights of the Nation reserved by means of the Constitutional changes, it is noteworthy that in the case of Pemex there is no mention whatsoever of its authority as a instrumentality of the State, as there is for the CFE.

1.3.3. Seventh paragraph (new).

The Constitutional limitation is established so that private companies may not produce more than 46% of the electric energy required by the country, as well as the fact that the CFE will be the only one that may provide the public service of electric energy supply. In other words, only the CFE will be able to offer electricity supply service to any user in Mexico.

1.3.4. Elimination of the current eighth paragraph.

Regarding hydrocarbons, without a doubt the most talked about and discussed elimination because it eliminates from the Constitutional text the existence of the National Hydrocarbons Commission ("**CNH**") and the Energy Regulatory Commission ("**CRE**" and together with the CNH the "**Regulatory Bodies**") has been the elimination of the current eighth paragraph of article 28 of the CPEUM. The text proposed to be eliminated is as follows:

> ~~The Executive Branch will have coordinated regulatory bodies in energy matters, called the National Hydrocarbons Commission and the Energy Regulatory Commission, under the terms determined by law.~~

In this case, the Third Transitory Provision of the Decree contained in the Bill establishes that the structure and attributions of the Regulatory Bodies "are incorporated" to the SENER.

According to the transitory provisions of the 2013 Energy Reform,[18] the CNH and the CRE are responsible for, respectively:

(i) providing technical advice to SENER, the gathering of geological and operational information; the authorization of reconnaissance and surface exploration services; carrying out bids, award of winners and execution of contracts for the activities of hydrocarbons' exploration and extraction; the technical administration of contracts and entitlements; the supervision of extraction plans, and the regulation of hydrocarbons' exploration and extraction; and

(ii) the regulation and granting of permits for the storage, transportation and distribution by pipelines of petroleum, gas, refined products and petrochemicals; regulation of open access to pipelines and storage of hydrocarbons and their derivatives, among others.

Since today the CPEUM expressly establishes that the CNH is in charge of entering into contracts for the exploration and extraction of hydrocarbons, in order to provide legal certainty to the counterparties to such contracts, it should be established that the SENER, on behalf of the Mexican State, will exercise the rights established therein, as well as carry out contractual compliance.

The same applies to the CRE. Since its regulatory powers in the area of hydrocarbons are expressly established in the transitory provisions of the CPEUM, we consider that the transitory provisions of the Bill should establish, in a clearer manner, the powers of SENER in such matters. This, with the purpose that the Congress of the Union, as appropriate, may carry out the respective adjustments to the Organizational Law of the Federal Public Administration and the Hydrocarbons Law.

By eliminating the Regulatory Bodies from the Constitutional framework, the "regulatory state" model in the energy sector is abandoned, said model establishes as a fundamental principle that the State will create and promote the specialization of bodies with

[18] *See*: Tenth Transitory Provision of the DECREE amending and adding provisions of the Political Constitution of the United Mexican States, on Energy Matters published in the Federal Register on December 20, 2013.

technical and decision-making independence. The SENER, in addition to having clear conflicts of interest with the regulated parties (*e.g.*, Pemex),[19] will be an eminently political body that, by its own legal and factual nature, will privilege political decisions over technical ones. Given that article 27 of the Constitution and the transitional provisions of the 2013 Energy Reform related to obtaining revenues and maximizing oil resources[20] would remain in force even with the approval of the Bill, there may be a legal clash between the nature of SENER and such Constitutional principle.

As to the jurisdictional part, all acts and omissions of SENER would have to be challenged according to the Federal Law on Administrative Procedure or the administrative contentious laws,[21] since the requirement or limitation to challenge the acts of the Regulatory Bodies through an *amparo* action would be repealed when the Law of the Coordinated Regulatory Bodies in Energy Matters is repealed.

Although, unlike the electric power generation permits, the text of the Bill does not jeopardize the legal viability or existence of the permits granted by the CRE or the contracts for the exploration and extraction of hydrocarbons executed by the Mexican State, if the Bill is approved in its current terms, this would result in further delays in the acts filed before the Regulatory Bodies. Furthermore, in the case of matters currently regulated by the CRE, the granting of new permits for such activities would possibly be even more restricted.

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[19] It is possible that by transforming Pemex and CFE into "State instrumentalities" the boards of directors required for such EPEs will be dissolved or will no longer be required; a situation that the Congress of the Union will have to detail in the secondary legislation. In the case of Pemex, it is the Constitution itself (Twentieth Transitory Provision) which establishes that the Secretary of Energy will chair the Board of Directors of Pemex.

[20] If the Bill is approved, the now eighth paragraph of article 27 would establish: "*In the case of petroleum and solid, liquid or gaseous hydrocarbons in the subsoil, the property of the Nation is inalienable and imprescriptible and no concessions will be granted.* ***<u>In order to obtain income for the State that will contribute to the long-term development of the Nation</u>****, the latter will carry out the activities of exploration and extraction of petroleum and other hydrocarbons through entitlements to State instrumentalities or through contracts with them or with private parties, under the terms of the Regulatory Law. In order to comply with the purpose of such entitlements or contracts, the State instrumentalities may contract with private parties. In any case, the hydrocarbons in the subsoil are property of the Nation and it must be so stated in the entitlements or contracts.*". [Emphasis added.]

[21] Although it is true that the Courts had already issued criteria eliminating (or watering down) such limitation for violating the CPEUM itself, the regulated parties could still explore this route to fight various acts of the CRE and the CNH.

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2. TRANSITORY PROVISIONS.

We consider that except for the Third, Sixth[22] and Ninth Transitory Provisions, the transitory provisions of the Decree contained in the Bill are limited to the electricity industry.

The Third Transitory Provision establishes the following:

> *Third. The National Hydrocarbons Commission and the Energy Regulatory Commission are abolished. Their structure and attributions are incorporated to the Ministry of Energy, as applicable.*

In Section 1.3.4 of this document, we analyzed some of the most important consequences of the disappearance of the Regulatory Bodies. In Section 3 *infra* we make recommendations as to what should be included as a transitional regime if it is decided to eliminate the Regulatory Bodies.

3. SOME SUGGESTIONS.

In addition to the obvious suggestion to maintain the "regulatory State" model by respecting the existence of the Regulatory Bodies as they have been functioning and operating since 2014, we consider that, in order to avoid (or minimize) possible negative impacts to the hydrocarbons industry, at least the following changes should be made to the text of the Decree included in the Bill:

(i) Eliminate the concept of "*energy security and self-sufficiency of the Nation*" in article 25 of the CEPUM because, if added, it elevates to a Constitutional level a fundamental argument and justification that the federal government through SENER has been using to, among other things: (**a**) make amendments to the Hydrocarbons Law regarding the suspension of permits; (**b**) restrict or flat out deny the granting of permits for the import and export of Refined Products; and (**c**) possible restrictions to the export activities of hydrocarbons produced in Mexico.

[22] "***Sixth.*** *The mining concessions already granted by the Mexican State and for which gold, silver, copper and other minerals are already being explored and/or exploited are preserved in the terms in which they were granted. However, these concessions do not cover the exploitation and production of lithium.*
To the mining concessions already granted by the Mexican State and in which to this date there is a history of lithium exploration duly endorsed by the Ministry of Economy, the restriction referred to in the preceding paragraph will not be applicable."

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(ii) Limit the concept of Energy Transition, as well as the broad power of the Nation to take advantage of "the goods and natural resources"[23] required for such purposes.

(iii) Establish that all legal acts entered into by EPEs under the legal nature of State productive enterprises will be respected in their terms. Although this may possibly be a matter for changes to, or enactment of, secondary legislation (*e.g.*, Law of Petróleos Mexicanos and the Hydrocarbons Law), it is important to be clear about the possible risks and consequences derived from the transformation of EPEs into "*State instrumentalities*".

(iv) Establish in the transitory provisions of the decree that eventually amends the Constitution the powers that are expressly transferred to SENER in hydrocarbons matters when the Regulatory Bodies cease to exist, including, but not limited to the basic principles of maximization of hydrocarbons resources and the implementation of the best international practices for such industry. As discussed before, said principles are expressly granted to the CNH and the CRE in the Constitutional text.

We reiterate that this analysis is not intended to cover all issues and risks related to the Bill but is rather limited to highlighting the most relevant risks and impacts for the oil and gas sector in Mexico. Of course, the secondary legislation that Congress will issue or amend, as the case may be, will be the piece that determines whether these impacts are manifested to a greater or lesser degree, but there is no doubt that we believe that at least the Bill would grant the legislative power with such authorities.

This does not and is not intended to represent legal advice or a legal opinion regarding the Bill or its effects.

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[23] *See* proposed amendments to the sixth paragraph of article 27 of the CPEUM.