THE NEW LAW OF PETROLEOS MEXICANOS AND THE BASIS OF THE MEXICAN SERVICE CONTRACT

By Luis Enrique Cuervo
March 3, 2009

In November 2008, Mexico took some baby steps toward attracting foreign private international interests to its oil and gas industry. While a Constitutional bar to foreign investment in the oil and gas upstream operations has been preserved and Lázaro Cárdenas may still rest peacefully in his graveyard, some minor amendments have been introduced toward improving the business environment for international oil companies.[1]

Access to additional reserves has become difficult and expensive. Mexico's most promissory fields are located offshore[2] and some may extend beyond maritime international borders with the United States. Many in the oil and gas industry wonder whether PEMEX has the necessary resources to locate new reserves and extract them. Mexicans expect that petroleum revenues improve their daily lives and since PEMEX is the largest Mexican company and the source of at least one third of the Government's revenues any amendment to its corporate structure and way to conduct business becomes an issue of prime national interest.

Mexico's balancing act consists in preserving its very strong nationalistic claims over oil and gas resources, and a State controlled monopoly, while at the same time attracting foreign companies that may help boost production levels and thus increase revenues, profits and social well being. When the international press focuses on violence, drug related crimes, huge criminal organizations that control parts of the territory, and talk of a "failed state", tourists and international investors usually go somewhere else.

Under harsh circumstances Latin American jurisdictions usually apply the same remedy: change the local legislation.

The new legislation confirms the State's permanent sovereignty over its hydrocarbon resources.[3] The recent changes will allow PEMEX to obtain foreign financing, contract under different rules with multinational oil and gas operators, sell investment bonds to ordinary Mexican citizens and try to transform itself into a cost effective and sustainable oil and gas operator.

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[1] International arbitration is one of the ABC's of a favorable investment scenario for international oil companies. International arbitration may still not be inserted in PEMEX contracts to be performed in Mexico under the provisions of Article 6 of the Regulatory Law of Constitutional Article 27 *(Ley Reglamentaria del Artículo 27 Constitucional en el Ramo del Petróleo)*. Arbitration may be agreed to but governed by Mexican Law.

[2] According to the Department of Energy "the largest concentration of remaining reserves occurs offshore in the southern part of the country, especially in the Campeche Basin". See Energy Information Administration, available at http://www.eia.doe.gov/cabs/Mexico/Oil.html last consulted on March 4, 2009.

[3] See Articles 1 and 2 of the Regulatory Law of Constitutional Article 27. The Mexican State is the sole owner of all resources and has the monopoly to conduct oil and gas exploitation.

Following a trend similar to the Brazilian and Colombian oil and gas regulatory models[4] the recent legislative reform creates a **National Hydrocarbon Commission** (NHC) responsible for the country's oil and gas policy and to act as Registrar of oil and gas contracts and operations.[5] Although the NHC does not control yet access to the nation's hydrocarbons reserves, such could be the future next step if and when a Constitutional amendment to article 27 is approved.[6] Amendments to Regulatory Law of Constitutional Article 27 reiterate the principle of permanent sovereignty over hydrocarbon resources now making specific reference to reserves that may be located in the continental shelf and exclusive economic zone.[7] In this sense the law could become an example under public international law of a specific claim over natural resources beyond the limits of the territorial sea.

While **the Mexican State and PEMEX maintain their exclusive monopoly over hydrocarbon reserves**[8] and upstream oil and gas activities it is unclear what could be the scope of the oil and gas policy to be developed by the NHC.

A new paragraph to Article 4 of Regulatory Law of Constitutional Article 27 provides the legislative guidelines of PEMEX's oil and gas policies and activities. Under this provision, PEMEX shall operate in consistency with Mexican national interests, including **energy security**, **hydrocarbon extraction sustainability**, **market diversification**[9] and **environmental protection.**

On October 28, 2008 the Mexican Congress approved a new statutory law for PETROLEOS MEXICANOS (PEMEX), the country's national oil company.[10] The law[11]

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[4] Colombia and Brazil created a National Hydrocarbon Agency responsible for awarding contracts over the States oil and gas E&P acreage and severed such powers from the national oil company, as had been the case for decades. The Mexican legal reform also created a National Hydrocarbon Commission but preserved a monopoly over the State's oil and gas E&P acreage reserved to PEMEX.

[5] See National Hydrocarbon Commission Law published in the Official Gazette on November 28, 2008.

[6] One of the legislative drafts contemplated the designation of strategic areas and limiting the State's upstream monopoly to such areas. The approved version of Regulatory Law of Constitutional Article 27 dropped such wording.

[7] Article 1 of Regulatory Law of Constitutional Article 27 provides that the Mexican nation is the direct owner of all hydrocarbon resources found in the country's territory, and including the continental shelf and the exclusive economic zone beyond the territorial sea. The article also addresses the issue of reserves that may be located in areas covered by international conventions or international borders, which are referred to as "cross-border reservoirs". Exploitation of cross border reservoirs requires a treaty to which Mexico is a party pursuant to article 2 of the Regulatory Law.

[8] Under article 5 of Regulatory Law of Constitutional Article 27 PEMEX and its subsidiaries have an exclusive right to obtain exploration and exploitation licenses from the Secretary of Energy. Previous wording of this article did not include the terms "exclusively" or "subsidiaries".

[9] Mexico is the third top supplier from which the United States imports its crude oil after Canada and Saudi Arabia. Thus, a policy of market diversification would not be in the best interest of the United States.

[10] See LEY DE PETROLEOS MEXICANOS. Published in the Official Gazette on November 28, 2008. Available at http://www.cddhcu.gob.mx/LeyesBiblio/pdf/LPM.pdf last consulted on March 2, 2009. The members of the Mexican Senate approved the law in a different location as followers of Manuel López Obrador blocked access to the Congressional building.

[11] The law is officially known as "Decreto por el que se expide la Ley de Petróleos Mexicanos; se adicionan el artículo 3o. de la Ley Federal de las Entidades Paraestatales; el artículo 1 de la Ley de Obras Públicas y Servicios Relacionados con las Mismas y un párrafo tercero al artículo 1 de la Ley de Adquisiciones, Arrendamientos y Servicios del Sector Público."

includes the basic provisions that govern PEMEX and its monopoly over Mexican oil and gas business.

In addition to the new PEMEX Law, the energy legislative reform included amendments to the Law of Regulations of Article 27[12], Law for the Sustainable Use of Energy, Law creating the National Hydrocarbon Commission,[13] Law for the Use of Renewable Energy and Finance of Energy Transition,[14] amendments to the Organic Law for the Federal Public Administration[15], and amendments to the Energy Regulatory Commission.[16]

The new law confirms PEMEX's monopoly over Mexico's oil and gas and petrochemical business being thus consistent with the limitations imposed by article 27 of the country's Constitution.

PEMEX is defined under the law as a decentralized entity[17] with its own legal personality and patrimony. Its corporate purpose is to explore and exploit oil and gas resources in addition to conducting petrochemical business.

PEMEX favored an amendment to its statutory law to update to the new international petroleum industry realities including technological advances, and environmental and economic challenges. Through the reform PEMEX expects to increase its production of crude oil, gas and refined products. Further, through the reform a special legal regime different than the one that applies to other state owned entities and proper of the oil and gas industry will apply to PEMEX contracts.[18]

The amendment to PEMEX's statutory law was presented as the solution to several problems including several years of lower petroleum production, lower hydrocarbon reserves, and lower petroleum exports. PEMEX has reported production declines in the country's two main fields *Cantarel* and *Ku Maloob Zaap*. Hydrocarbon reserves are not being replaced. Instead Mexico became an importer of four out of ever ten liters of the gasoline it consumes. PEMEX's production costs are on the rise and its oil and gas transportation infrastructure is outdated and reached its limits.[19]

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[12] Amendments to Ley Reglamentaria del Artículo 27 en el Ramo del Petróleo.
[13] The law is known as: "Decreto por el que se expide la Ley de la Comisión Nacional de Hidrocarburos."
[14] The law is known as: "Decreto por el que se expide la Ley para el Aprovechamiento de Energías Renovables y el Financiamiento de la Transición Energética."
[15] See "Decreto por el que se reforma y adiciona el artículo 33 de la Ley Orgánica de la Administración Pública Federal."
[16] See "Decreto por el que se reforman, adicionan y derogan diversas disposiciones de la Ley de la Comisión Reguladora de Energía."
[17] PEMEX has a fifteen member Board of Directors and a CEO appointed by the Mexican President (Federal Executive Branch), and all of which are considered public servants. See articles 7 and 36 of the law.
[18] See PETROLEOS MEXICANOS. Poqué se propone crear una Nueva Ley Orgánica de Pemex? Available at http://www.pemex.com/index.cfm?action=content&sectionID=136&catID=11886 last consulted on March 2, 2009.
[19] See PEMEX at http://www.pemex.com/index.cfm?action=content&sectionID=136&catID=11860 last consulted on March 2, 2009

In presenting, discussing and approving a bill for PEMEX's reform a critical issue was clearly confirmed: oil and gas in Mexico and the so called "*renta petrolera*" or income[20] derived therefrom are exclusively Mexican.[21]

What the most recent legal reform does not change.

The following paradigms of Mexican oil and gas law still stand after the most recent legislative amendment:

-The **Mexican State is the sole owner of all hydrocarbon reserves.**[22] Private parties may not be granted rights over Mexican hydrocarbon resources which may only be State owned assets.[23]

-The Mexican **State's monopoly over oil and gas resource exploration and exploitation** is preserved.[24] Licenses to conduct E&P operations may only be granted to PEMEX.[25]

-PEMEX is a one hundred percent State oil company and will not be privatized.

-The limitations imposed by the wording of article 27 of the Mexican Constitution are not modified.

The most significant changes include: contracts executed by PEMEX will not be limited by the Public Works and Services Law, Oil and Gas Service Contracts governed by the new legal scheme may be executed, and PEMEX may contract debt abroad.

Before the New PEMEX Law was enacted, all PEMEX contracts were governed by the Public Works and Services Law.[26] Such law applies to construction works but is alien to oil and gas exploration and exploitation activities.

The new law allows PEMEX to negotiate oil and gas service contracts with foreign companies under a scheme that while not yet a production sharing contract it provides for compensation in cash to a foreign operator for E&P activities.

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[20] The so called: "renta petrolera" or difference between income derived from petroleum production and the cost of such production.
[21] "El petróleo y la renta petrolera son y seguirá siendo de los Mexicanos." See PEMEX at http://www.pemex.com/index.cfm?action=content&sectionID=136&catID=11880 last consulted on March 2, 2009.
[22] See article 60.I of the new PEMEX Law.
[23] See article 60.II of the new PEMEX Law.
[24] See article 60.III of the new PEMEX Law.
[25] See article 5 of Regulatory Law of Constitutional Article 27.
[26] See Ley de Obras Públicas y Servicios Relacionados con las mismas.

New E&P Service Contract

The new law does not elaborate on the contents of a new service contract. Its basic consequence is that PEMEX may execute new service contracts that will not be limited by the Federal Law that governs Public Works. Operators may not be compensated in kind or through a share of production. Article 5 of the new law provides that hydrocarbons are an exclusive property of the Mexican State and remain under its exclusive control. Thus, what will be the specific terms and conditions of the new service contracts remains to be seen.

Notwithstanding the above, the basic provisions of the new Service Contracts will be the following:

-the new contracts may not be production sharing contracts.[27]

-PEMEX contractors may not be paid in kind from crude oil production.[28]

-payment for services will be made only in cash and not through a percentage of petroleum production.

-oil and gas contracts may not adopt association or joint venture schemes.

-contracts may provide compensation for benefits derived from technological developments.

-contracts may take into account the variations of international petroleum prices.

-contractor's compensation will be fixed or tied to a previously agreed formula.

-contracts may contemplate a bonus scheme whenever PEMEX receives greater profits, benefits from new technology or saves costs.

-arbitration may be inserted to excluding the jurisdiction of Mexican courts.[29] Further, the new law enables PEMEX to agree on the applicability of foreign law and to the jurisdiction of foreign courts or international arbitration whenever they execute international contracts.

-PEMEX is responsible as a matter of law for any damages to the environment and must conduct its operations considering principles of sustainable development.[30]

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[27] See article 6 Regulatory Law of Constitutional Article 27.
[28] Id.
[29] See article 72 of the new PEMEX Law. However, article 6 of Regulatory Law of Constitutional Article 27 provides that whenever services are to be performed in Mexico, arbitration may be conducted pursuant to Mexican law including Treaties to which Mexico is a party.
[30] See articles 7bis and 9 of Regulatory Law of Constitutional Article 27.

PEMEX is entitled by law to file any necessary actions to prevent environmental damages and to obtain compensation whenever said damages are caused.[31]

PEMEX may seek Foreign Financing

Under article 44 of the new law PEMEX may contract debt abroad and in foreign currency with no previous authorization from the Mexican Treasury Department.[32] PEMEX may seek foreign financing sources within the limitations of its payment capabilities.[33]

By not having to obtain approvals from the Mexican Treasury, PEMEX may act promptly responding to the needs of its oil and gas business.

PEMEX may issue savings bonds

The law authorizes PEMEX to issue saving bonds (*bonos ciudadanos*). The bonds may only be purchased by Mexican citizens and corporations[34] and through them PEMEX may obtain local financing while allowing a degree of participation in the country's most important company to many Mexican citizens. The Mexican Treasury will determine what will the main characteristics and terms and conditions of said bonds. The bonds are not shares and through them no interest in PEMEX as a corporate entity is acquired. Further, through the bonds no ownership in the nation's hydrocarbon reserves is obtained. The bonds will act as a form of investment with the country's largest and most important company. Investment returns will be tied to PEMEX's corporate performance. Funds raised through these savings bonds may only be used in "productive works" with expected high financial returns.

Conclusion

The Mexican upstream oil and gas industry remains closed to foreign investors. However, PEMEX will not expect that service providers in performing their operations abide by the inappropriate Public Works Law. Instead, now PEMEX may execute new Service Contracts that may contemplate arbitration governed by Mexican law.

Whether the new contracts become a new model for the international petroleum industry remains to be seen.

Baby steps indeed but certainly steps that may become the initial noise to disturb the peace in Lázaro Cárdenas' graveyard.

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[31] The amendments to Regulatory Law of Constitutional Article 27 include provisions that require PEMEX to avoid the flaring of gas, oil spills and damages to the environment.
[32] Secretaría de Hacienda y Crédito Público.
[33] See article 44.III.a) of the PEMEX Law.
[34] See article 47 of the PEMEX Law.