

**Mexican Energy Reform:**  
**The New Enacted Hydrocarbons Law.**

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The opening of the Mexican energy sector (the “Sector”) has been finally achieved with the approval by the Mexican Senate on August 5, 2014 of the energy bills which have been discussed in the Mexican Congress as a result of the Mexican Constitutional Reform previously published in December of 2013. The bills were sent to the Executive for its publication in the Official Gazette and the new era in the Sector in Mexico will immediately begin.

The package of the proposed amendments which was submitted by President Enrique Peña Nieto last April has been the basis for the Legislative branch to deepen the reforms that were finally applied to the Mexican legal framework to give effect to the sweeping changes that have been made to the Sector, including among others the welcoming of domestic and foreign private investment in the Sector and the operation of new regulatory agencies.

This is a summary of the amendments made to Mexican energy legal framework:

<b>Industry</b>	<b>Proposed New Laws</b>	<b>Amended Laws</b>	<b>Abrogated Laws</b>
Hydrocarbons Industry	- Hydrocarbons Law	- Foreign Investment Law - Mining Law - Public-Private Associations Law	- Regulatory Law of Constitutional Article 27 Related to Oil Matters - Regulation on the Mining Law regarding Associated Gas of Coal Deposits
Electric Industry	- Electric Industry Law		- Electric Power System Public Service Law
PEMEX and CFE	- PEMEX Law - CFE Law	- Federal Law of State-Owned Entities - Acquisitions, Leasing and Public Sector Services Law - Public Works and Related Services Law - Public Debt Law - Federal Law on Budget and Treasury Responsibility	- Petroleos Mexicanos Law
Hydrocarbons’ Revenues	- Hydrocarbons Revenues Law	- Fiscal Coordination Law - Federal Law of Royalties	- Regulation on the Mining Law regarding Associated Gas of Coal Deposits
Industrial Security and Environmental Protection of the Sector	- Law of the National Agency of Industrial Security and Environment Protection of the Hydrocarbons Sector		
Sector’s Regulatory Agencies	- Law of the Coordinated Regulatory Agencies of the	- Organizational Law of the Federal Public Administration	- Energy Regulatory Commission Law

	Energy Sector		- National Hydrocarbons Commission Law
Mexican Oil Fund	- Law of the Mexican Oil Fund for Stabilization and Development		
Geothermal Energy	- Geothermal Energy Law	- National Waters Law	

We at JATA share the idea that the new structure of the Sector has the potential of encouraging the economic development of our country in the coming years. The upcoming participation of private investment in the two largest industries of the Sector (hydrocarbons and electricity) is mainly described in the Hydrocarbon's Law and the Electric Industry Law, respectively, and for that reason their analysis is essential for any potential investor in those industries. Consequently, we have prepared a summary of the most relevant aspects of the approved Hydrocarbons Law and we are open and available to discuss with our clients and friends any particular aspects of these laws or any other rules related to the Sector.

### **Hydrocarbons Law (the "Law").**

The Law, directed to modify the hydrocarbons' industry, eliminates certain exceptions formerly included in the Regulatory Law of Constitutional Article 27 Related to Oil Matters, the Regulation on the Mining Law regarding Associated Gas of Coal Deposits, and amends the Foreign Investment Law, the Mining Law and the Public-Private Associations Law.

#### **a. Scope**

As we mentioned above, most of the Oil & Hydrocarbons sector's activities, processes, and authorities' functions will be mainly regulated by the Law, including the new constitutionally permitted involvement of private companies and/or individuals in the activities of the upstream sector (exploration and exploitation), as well as the required authorizations and permits to perform most of the activities of the midstream and downstream sectors.

Moreover, the Mexican gas industry is particularly amended through this Law by the establishment of new rules applicable to the industry, such as the free and non-discriminatory access to the gas and other hydrocarbons in Mexico, as well as by the creation of the National Center of Natural Gas Control (*Centro Nacional de Control del Gas Natural* or *CENACE*), which will be responsible for operating the Mexican pipeline network, mainly replacing PEMEX in such area.

#### **b. Upstream activities**

As it had been already introduced in the Constitutional Reform, the Mexican exploration and production ("E&P") activities will be performed either by "productive State companies" (PEMEX or subsidiaries), or by private companies.

The Mexican State, through what is known as Round Zero, will assign in favor of the productive state companies the rights to continue performing the E&P activities, which are expected to be officially assigned around September 2014, following the timing proposed by the Constitutional Reform and according to Pemex' request timely submitted on March of 2014. The Round Zero assignments will only apply in favor of PEMEX or its subsidiaries, and once this process is concluded the Mexican State will begin the new bidding processes in which private companies will be able to participate, presumably side-by-side with PEMEX or its subsidiaries, in order to perform such activities by entering into contracts with

the National Hydrocarbons Commission; such bidding processes are expected to begin during the first semester of 2015.

Furthermore, the Law provides that PEMEX and its subsidiaries will be able to request to the Ministry of Energy the transformation of its current contracts and/or assignments (including those resulting from Round Zero) into E&P contracts in which private companies may also participate, via public bids. Pursuant to the Law, PEMEX and its subsidiaries will be allowed to enter into contracts or joint ventures with private companies for the performance of its E&P activities, or for the joint participation in public bids for E&P contracts.

The contractual framework, which is generally detailed in the Hydrocarbons Revenues Law, includes (i) services contracts, paid in cash; (ii) profit-sharing contracts, paid with a profit percentage; (iii) production-sharing contracts, paid with a percentage of the output production; and (iv) license contracts, paid with the transmission of the extracted hydrocarbons' ownership. Aside from the service contracts, any private company entering into any of the other three contracts will have to pay to the Mexican State: (i) a contractual quote; (ii) royalties; (iii) a fee, determined by a percentage of the operative profit; and (iv) a signing bonus for licenses, which will be determined in the corresponding public bidding.

Regarding E&P contracts, the Law allows for the booking of reserves for financing purposes; it will be permitted with the single condition of asserting that the ownership of the oil and hydrocarbons in the subsoil belong to the Mexican State.

E&P contractors will require authorization by the National Hydrocarbons Commission to perform activities of well drilling, and every person will be able to request authorization of the National Hydrocarbons Commission for the performance of the superficial exploration activities. The Mexican Congress included the provision that neither an assignment nor E&P agreement may be granted in "protected natural areas".

### **c. Midstream and Downstream activities**

As included in the Constitutional Reform, the oil and hydrocarbons' midstream and downstream sectors are now completely open for the participation of private parties. This participation however will be subject, without exception, to the issuance of a permit by the relevant Mexican authority, starting on 2015. These permits will be obtained upon application and compliance of certain requirements based on the activity intended to be performed as licensee.

Permits for the activities of oil treatment and refining, natural gas processing, import/export of hydrocarbons, and oil-bearing fuels (gasoline, diesel, kerosene, fuel oil, LPG, among others) will be granted by the Ministry of Energy.

Permits for the storage, transportation, distribution, compression, liquefaction, decompression, regasification, commercialization and retailing of hydrocarbons, oil products and petrochemicals, as well as the management for integrated systems, will be granted by the Energy Regulatory Commission.

Permits granted prior to the effectiveness of the Law will retain their full force and effect in their respective terms, and those currently involved in the activities that require a permit and do not have one must obtain it no later than 2015. Although some of the midstream and downstream activities were already allowed to private parties, the opening of the Sector is now complete; however, not all the

activities referred to in the immediately preceding paragraphs may be allowed immediately for private parties, and in that sense, the legislators included the following transitional regime for these activities in the transitory articles of the Law:

- Permits for retail sale of gasoline and diesel will be granted by the Energy Regulatory Commission starting on 2016;
- Permits for the import of LPG will begin to be granted in 2016 (or earlier if market conditions allow it);
- Permits for the import/export of gasoline and diesel will begin to be granted in 2017 (or earlier if market conditions allow it);
- The effectiveness of the supply agreements subscribed by Pemex or its subsidiaries shall not exceed December 31, 2016; and
- Permits for transportation, storage and distribution of LPG which are not linked to pipelines and are for its retail sale will continue to be granted by the Ministry of Energy until December 31, 2015, and will be granted subsequently by the Energy Regulatory Commission.

#### **d. Land use and occupancy**

The Law provides that the consideration and the terms and conditions for the use, enjoyment or allocation of land, assets or rights which are necessary to perform E&P activities may be agreed between the owners (including the holders of property or communal rights) and the assignees or contractors. Additionally, it provides that the Law is subject to the rights that the Constitution, laws and international treaties recognize for indigenous communities. It is therefore important to keep in mind that since years back the ILO Convention 169 (*Convention Concerning Indigenous and Tribal Peoples in Independent Countries*) has been the reference regarding the rights of indigenous and native communities in order to determine the appropriate applicable legal treatment when communal rights are involved.

Additionally, the Law also provides that the consideration to be paid to the owners of land should be enough to cover, if applicable: (i) the payment for the affectation to property or rights other than land, as well as damages; (ii) income derived from occupation, easement or land use; and (iii) a percentage of the revenue accruing to the assignee or contractor, which in case of non-associated natural gas, it shall not be less than 0.5% nor more than 3%, and for all other cases, it may not be less than 0.5%, nor more than 2%, after deducting the applicable payments owed to the State. Different forms of compensation, in addition to payment in cash, may be agreed. The agreements reached by the parties shall be submitted before a District Judge or competent Land Court to be validated.

Additionally, and consistent with the qualification of the activities of the Sector as strategic and of public interest, the Law introduces a new Mexican law figure of “Hydrocarbons Easement” (*Servidumbre legal de hidrocarburos*) which will be created for the performance of activities and/or the right of way, among other rights, in connection with an E&P contract. The purpose of this figure is to allow companies involved in the Sector to share the possession and use of land with its owners during the E&P process, considering, however, that in case that the parties don’t reach an agreement, the Hydrocarbons Easement may be promoted before a Civil District Judge or competent Unitary Agrarian Tribunal or otherwise initiate before the Ministry of Agrarian, Territorial and Urban Development a mediation process by which the parties may agree on the methods of acquisitions, use, enjoyment or allocation of land, assets or rights and the corresponding consideration to be applied.

#### **e. Key elements**

The Law comprises most of the relevant amendments to the Mexican oil and hydrocarbons' industry; nevertheless, such changes were widely expected since the Constitutional Reform was passed, and therefore, the text proposed by the Executive and the additions made by the Legislative are within those which were expected and necessary to begin the modernization of the Sector.

Notwithstanding the foregoing, we have identified the following important elements which have been introduced to the Sector by the Law:

- For purposes of an E&P contract, besides the productive state companies, only private corporations duly organized and existing under the laws of Mexico, whether with domestic or foreign capital, will be considered as contractors. Hence, foreign companies will not be able to appear directly as such in the public bids to be organized by the Mexican State, nor will their Mexican branches, but rather they will need to participate through Mexican subsidiaries incorporated under Mexican Corporations' Law.
- E&P contracts with cross-border oilfields will require a mandatory participation of PEMEX or another productive state company in at least 20% percent of the project's investment.
- E&P contracts will need to have the participation of a minimum "national content" which will increase gradually, starting with 25% on 2015, and will reach a maximum requirement of at least 35% in 2025. Deep-water activities are excluded from these thresholds, and in such case the Ministry of Energy will issue the applicable thresholds, as applicable.
- The pipeline transportation systems and the facilities for the storage of natural gas, oil-bearing and petrochemicals which are interconnected may form "integrated systems" to expand coverage and provide for the reduction of costs, expecting to increase the certainty, continuity and quality of the provision of services.
- The prices of gasoline and diesel will be determined under market conditions starting on 2018, and LPG prices starting on 2017.
- The existing incentivized agreements remain unaffected in their terms, and the contracting parties may request their migration to E&P agreements.
- The Law contains a special chapter with certain conducts that will be specifically sanctioned as corrupt practices within the Sector. This is an item of special relevance for the overall amendments and key for private Mexican and global companies seeking to become involved in the Sector.
- It is important to confirm that, as expected, the ownership spirit of the hydrocarbons in the subsoil is not changed in the Law, and precisely following the Constitutional Reform, belongs at all times in the Mexican State. As stated before, ownership of hydrocarbons will only be transferred to private entities *after their extraction* under the license agreements, and only after all applicable payments to the Mexican government have been paid.

JATA is a Mexican law firm with offices at Monterrey, Mexico and Houston, Texas. Please do not hesitate to contact us with any comments or concerns regarding the reform and its implementation in practice.

#### Legal Note.

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Do not hesitate to contact us at our numbers below for professional legal advice on the subject matter of this memorandum or for any further information, comments or questions. We will be very glad to help you.

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