

## Client Alert: New Energy Legal Framework in Mexico

Mexico City, August 4, 2014

Resulting from the amendments to the Constitution of Mexico, as published in the Official Gazette (*Diario Oficial de la Federación*) on December 20, 2013 (the “Energy Constitutional Reform”), a comprehensive set of proposed new statutes and modifications to existing laws were brought by the President of Mexico before Congress, in the form of law initiatives.<sup>1</sup> Said law initiatives, generally referred to as secondary legislation, are intended to regulate and implement the Energy Constitutional Reform, thus setting forth the foundation for a new energy legal framework in Mexico. After months of negotiations, those statutes and law amendments have now been approved by the Mexican Congress and will enter into effect upon publication by the Executive branch.

Two are the industries that are being transformed as a result of this new legal framework, (i) oil and gas and (ii) electricity. Again, the overall objective of this energy reform is to provide for the participation of private investment, both domestic and foreign, in these industries. Prior to this law reform, oil, gas and electricity were controlled by *Petróleos Mexicanos* (“Pemex”) and the *Comisión Federal de Electricidad* (“CFE”), respectively, private investment being authorized exclusively in a limited catalogue of areas of business. Pemex and CFE are modernized turned into State Productive Entities (“SPEs”), and expected to participate in the marketplace and in a competitive environment. New, autonomous and strengthened regulators shall oversee the new markets and are to ensure open access to essential facilities and fair conditions to all participants, as well as safety and sustainable growth. All statutes include anti-corruption and transparency measures.

Below you will find the highlights of the new and amended statutes that will regulate these industries and that create, or strengthen, as the case may be, the regulatory agencies.<sup>2</sup>

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<sup>1</sup>The initiatives were organized in four packages, as follows: (i) Hydrocarbons Law (*Ley de Hidrocarburos*), Foreign Investment Law (*Ley de Inversión Extranjera*), Mining Law (*Ley Minera*), and Law on Public-Private Partnerships (*Ley de Asociaciones Público Privadas*); (ii) Electric Industry Law (*Ley de la Industria Eléctrica*), Geothermal Energy Law (*Ley de Energía Geotérmica*), and National Waters Law (*Ley de Aguas Nacionales*); (iii) Pemex Law (*Ley de Petróleos Mexicanos*), Federal Electricity Commission Law (*Ley de la Comisión Federal de Electricidad*), Federal Law on Government-owned Entities (*Ley Federal de Entidades Paraestatales*), Law of Acquisitions, Leases and Services of the Public Sector (*Ley de Adquisiciones, Arrendamientos y Servicios del Sector Público*) and Law of Public Works and Related Services (*Ley de Obras Públicas y Servicios Relacionados con las Mismas*); and (iv) Law of Coordinated Regulatory Agencies in the Field of Energy (*Ley de Órganos Reguladores en Materia Energética*), Organic Law of the Federal Public Administration (*Ley Orgánica de la Administración Pública Federal*) and Law of the National Agency for the Industrial Safety and Environmental Protection of the Hydrocarbons Sector (*Ley de la Agencia Nacional de Seguridad Industrial y de Protección al Medio Ambiente del Sector Hidrocarburos*).

<sup>2</sup>Please note that a second package of initiatives was brought by the Executive before the Lower House regarding budgetary and fiscal aspects of the Energy Reform. It comprises two sets of new or amended statutes: (i) Revenue Law of Hydrocarbons (*Ley de Ingresos sobre Hidrocarburos*), Federal Law of Government Fees (*Ley Federal de Derechos*), Tax coordination Law (*Ley de Coordinación Fiscal*) and the Law of the Mexican Oil Fund for the Stabilization and Development (*Ley del Fondo Mexicano del Petróleo para la Estabilización y el Desarrollo*); and (ii) Federal Law on Public Budget and Fiscal Responsibility (*Ley federal de Presupuesto y Responsabilidad Hacendaria*) and General Law of Public Debt (*Ley General de Deuda Pública*). The legislative process for these matters is still ongoing and therefore these laws are not referred to herein.

## **I. Oil and Gas**

### Hydrocarbons Law (Ley de Hidrocarburos)

- The new Law regulates the exploration and extraction of hydrocarbons; treatment, refining, sale, commercialization, transport and storage of oil; processing, compression, liquefaction, decompression and regasification, as well as the transportation, storage, distribution, commercialization and public sale of natural gas, petroleum products and, finally, the transportation and storage of petrochemicals.
- All hydrocarbons in Mexican subsoil remain direct property of the Mexican Nation. Exploration and extraction of such hydrocarbons are strategic activities that may only be performed by the Mexican Nation, through (i) assignments to State Productive Entities, or (ii) contracts with private entities (alone or in joint venture with an SPE), in either case limited to a certain geographic area and for limited time.
- Pemex or any other SPE that has been awarded an Assignment by the Ministry of Energy (Secretaría de Energía or “Sener”), may celebrate agreements with private entities to perform the authorized activities, and may do so through service contracts, or through contracts for shared production or shared profits.
- A goal of 35% of national content has been set for exploration and extraction activities, except for those in deep and ultra-deep waters. The Ministry of the Economy shall provide incentives for investment in domestic productive chains and oversee compliance of national content.
- Contracts for the exploration and extraction of hydrocarbons to be celebrated with private parties shall be executed by the newly-created Oil and Gas Commission (Comisión Nacional de Hidrocarburos, or “CNH”). Contracts shall be awarded through public bidding.
- The basic terms and conditions of such contracts are set forth in this law and its regulations (yet to be issued). Arbitration clauses are allowed, but always under Mexican Federal law.
- Sener shall remain the energy industry policy maker. In addition to granting assignments, it will have powers to grant permits and authorizations needed to secure the supply of hydrocarbons and the expansion of pipelines infrastructure, as well for treatment and refinement of oil, processing of natural gas, exports and imports of hydrocarbons and petroleum products.
- The Energy Regulatory Commission (Comisión Reguladora de Energía or “CRE”), will be in charge of granting permits and authorizations for the transportation, storage and distribution services of hydrocarbons, liquefied petroleum gas, petroleum products and petrochemicals. CRE shall issue regulations to ensure open, non-discriminatory access to pipelines and other essential facilities (within a year of the effective date of the Law).
- The new statute regulates and provides incentives for the creation of interconnected systems for transportation in pipelines and storage of natural gas, petroleum products and petrochemicals, to ensure efficient coverage, open access and service.
- The National Center for the Control of Natural Gas (Centro Nacional de Control de Gas Natural or “CENAGAS”) must be created within one year of this Law and shall manage the natural gas integrated transportation and storage systems, ensure the supply of natural gas and promote the growth of the pipeline infrastructure.

- The Law provides for a transition period for the commercialization of petroleum products, specifically through gasoline service stations, without the need of a Pemex franchise agreement and without being conditioned to the supply of Pemex products.
- Given that exploration and extraction activities may need to be performed in lands currently owned by private third parties or subject to communal property (ejidos), the statute provides for a temporary occupation of land regime. Consideration and terms shall be negotiated between the parties.
- The Executive shall issue the Regulations to this Law during the 180 natural days following the effective date of this Law. However, regulators may grant permits and authorizations immediately. The initial process for Assignments to Pemex, also known as Round Zero, will continue as provided for in the Constitutional Reform.
- First-hand sales of hydrocarbons, petroleum products and petrochemical shall be subject to asymmetrical regulations issued by CRE to limit Pemex's market power;
- Dates to keep in mind:
  - a) Contracts for the commercialization of hydrocarbons awarded to Pemex or other SPEs by CNH shall not extend further than December 2017, when this activity will be fully open.
  - b) Permits issued by Sener for treatment, refining and processing shall be held by all persons performing such activities no later than end of June, 2015.
  - c) Permits issued by CNH for compression, liquefaction, decompression, regasification, transport, storage, distribution or sale shall be obtained no later than end of December 2015.
  - d) Permits for imports of gasoline and diesel shall only be granted by CRE to Pemex or other SPEs until end of 2016, after which date permits will be available to anyone fulfilling applicable conditions.
  - e) Permits for sale to the public of gasoline and diesel shall be granted by CRE as of January 1st, 2016.
  - f) Sales of gasoline and diesel will be at market prices as of January 1st, 2018.

## **II. Electricity**

### Electric Industry Law (Ley de la Industria Eléctrica)

- The purpose of the statute is to promote sustainable growth in the electric industry and ensure its efficient, continuous and safe operation, as well as to provide for a universal and public service, clean energies and reduction of polluting emissions.
- It regulates the generation, transmission, distribution and commercialization of electric energy; the planning and control of the National Electric System (a strategic area under State control), and the operation of the wholesale electric market. The electricity supply is considered a public interest service, whereas the generation and commercialization of electricity are services subject to free competition.
- The industry shall be regulated by Sener and CRE.
- CFE is transformed into a State Productive Entity (see below). It will supply electricity to small, medium or

residential users.

- Large users and those who had permits for self-supply and cogeneration (not considered as part of the public service) are now allowed to hire the services in the market where the same are generated.
- Large or qualified consumers will need to be registered before CFE.
- The National Center for Energy Control (Centro Nacional de Control de Energía or “CENACE”) is created to operate the National Electric System, the operation of the system for large users and access to the national transmission infrastructure
- Any person may request interconnection to the national transmission infrastructure without having a generation permit.
- The statute promotes the generation of clean energies and a Clean Energy Certificate is created to be awarded by the CRE.
- The State may enter into agreements or joint ventures with private parties to perform the financing, installation, maintenance, operation and infrastructure needed to provide the public service of transmission and distribution of electric energy.
- The following activities must be carried out with strict independence from one another: generation, transmission, distribution, commercialization, and provision of primary inputs of the industry. Therefore, there will be strict legal, accounting, functional and structural separation among parties in the industry, to ensure open access and efficient operation of the electric sector.

### III. State Productive Entities (SPEs): PEMEX and CFE

- Pursuant to the new statutes (Petróleos Mexicanos Law and Federal Electricity Commission Law (see below)), both Pemex and CFE are transformed from State-owned companies with monopolies over their respective activities, to State Productive Entities. Their purpose shall be to create value and be profitable, rather than only contributing to public finances, although payment of a mandatory state dividend is provided for.
- Both PEMEX and CFE are subject to a special regime regarding corporate governance, compensation, procurement, goods, responsibilities, state dividend, budget, indebtedness, transparency and accountability. They are governed by their respective laws and, secondarily, by commercial and civil law, instead of by administrative law.
- As SPEs, Pemex and CFE shall be solely owned by the Federal Government, and shall have technical, operative, managerial and budgetary autonomy.
- The companies may carry out their respective activities by themselves, or through subsidiaries and affiliated companies, as well as by entering into agreements or joint ventures with domestic or foreign persons or entities.
- Corporate governance provisions applicable to both companies include the following: they will be managed by a Board of Directors, whose members (10) will be appointed by the Executive, with Senate approval. The Chairman of the Board will be the Minister of Energy and the labor union has not been given a seat. Board members shall be in charge of strategic decisions and be bound by duties of loyalty and diligence. The General Director will be appointed by the

Executive and will run the day-to-day operations.

- In order to enable SPEs to keep qualified employees and recruit new ones, the companies' workers shall not be subject to most statutory provisions applicable to federal employees, including salary caps, civil service and administrative responsibilities of public servants.
- To give them flexibility and ensure their competitiveness, Pemex and CFE are exempt from the application of the Federal Law on Government-owned Entities, the Law of Acquisitions, Leases and Services of the Public Sector and the Law of Public Works and Related Services, which were amended accordingly;
- Pemex and CFE will be able to issue debt or get loans as they deem convenient (subject to certain restrictions). Their obligations shall not be guaranteed by the Mexican State.

#### Petróleos Mexicanos Law (Ley de Petróleos Mexicanos)

- In addition to the provisions above this statute regulates the organization, operation, control and evaluation of Pemex, its subsidiaries and affiliated companies, now transformed into State Productive Entities (SPEs).
- Pemex's authorized activities are the exploration and extraction of oil and other hydrocarbons (solid, liquid or gas), as well as their processing, sale and commercialization.
- Pemex is no longer a regulator. Bidding processes for public works and projects, including upstream and downstream, will no longer be called for nor decided by Pemex.

#### Federal Electricity Commission Law (Ley de la Comisión Federal de Electricidad)

- CFE shall provide the public service of transmission and distribution of electricity. It has powers to import, export, transport, store, buy or sell natural gas, coal and any other combustible, in Mexico or abroad.
- To ensure open access, efficient operation and competition in the electricity industry, CFE shall perform each of the following activities with strict independence from one another: generation, transmission, distribution, commercialization, basic supply, qualified supply, last-recourse supply, primary inputs provision, and any and all auxiliary or connected activities. Therefore, there will be strict accounting, functional and structural separation among areas.

## **IV. Regulator and Agencies**

#### Law of Coordinated Regulatory Agencies in the Field of Energy (Ley de Órganos Reguladores Coordinados en Materia Energética)

- The coordinated regulators will be the Oil and Gas Commission (CNH) and the Regulatory Commission of Energy (CRE), now a part of the Centralized Federal Public Administration.
- Each of CNH and CRE will be governed by a board of 7 Commissioners proposed by the Executive and approved by the Senate, for 7-year terms. An Executive Secretary will prepare matters to be brought before the board.



- Provisions are set forth to ensure maximum publicity, transparency and avoidance of conflict of interest in the acts of these entities.
- A new Council for the Coordination of the Energy Sector is created, to facilitate coordination among the regulators, Sener, and other government agencies.
- The regulators will have powers to oversee and penalize all regulated parties in order to avoid any corruption practices, as well and prevent or sanction illicit practices.
- The acts and activities of these coordinated regulatory bodies will be subject to the Federal Law of Anti-corruption in Public Procurement.

## Law of National Agency for the Industrial Safety and Environmental Protection of the Hydrocarbons Sector (Ley de la Agencia Nacional de Seguridad Industrial y de Protección al Medio Ambiente del Sector Hidrocarburos)

- The Agency will be ascribed to the Ministry of the Environment and Natural Resources (Secretaría de Medio Ambiente y Recursos Naturales, or “Semarnat”) and is created to protect persons, the environment and the facilities of the energy sector through the regulation and oversight of industrial and operative safety, abandonment of facilities and control of residues and polluting emissions.
- It has powers to grant environmental licenses, authorizations and permits, issue all needed regulations for industrial safety and environmental protection, grant certifications as external auditor of the hydrocarbons sector, and impose penalties.
- The Executive Director of the Agency will be appointed by the President.
- The Agency will have a Technical Committee integrated by various Ministries of State.

## **V. Other relevant amendments**

### Geothermal Energy Law (Ley de la Energía Geotérmica)

- The purpose of this Law is to regulate the recognition, exploration and exploitation of geothermal resources for the use of thermal energy in the Mexican subsoil, in order to generate electricity.
- Private parties may register before Sener, who has the power to grant concessions for the exploration and exploitation of geothermal resources. Concessions grant their holders the right to use and exclusively exploit a geothermal field, for a period that shall not exceed 30 years.

### Foreign Investment Law (Ley de Inversión Extranjera)

- The catalogue of activities reserved exclusively to the Mexican State was modified to limit the general reserve of oil and other hydrocarbons, to the exploration and extraction of oil and hydrocarbons, only as provided by law; petrochemical activity is eliminated from the list; the planning and control of the National electric power system, the transmission and distribution of the electric power energy will be carried out in accordance to articles 25, 27 and 28 of the Mexican Constitution.

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- Only Mexican entities may participate in the commercialization of gasoline and distribution of liquefied petroleum gas as well as in the exploration and extraction services of hydrocarbons.
- Foreign investment over 49% in the construction of pipelines for the transportation of oil and its derivatives as well as in the perforation of oil and gas wells shall require favorable opinion of the Foreign Investment Commission.

## Mining Law (Ley Minera)

- This statutes shall not be applicable to oil and other hydrocarbons in the subsoil, including gas associated to coal found in mining coal fields.
- Although the general rule is that mining shall have a preferential right over other uses of the land, the exploration and extraction of oil and the transmission and distribution of electricity shall have a higher preference. Therefore, before granting a mining concession title, the Ministry of the Economy shall certify that the designated area will not have hydrocarbon activities.
- Rules for the co-existence of mining and extractive activities are to be issued.

## Public Private Partnerships Law (Ley de Asociaciones Público Privadas)

- PPPs may be established in oil refining and process of natural gas, as well as in the transportation, storage and distribution of hydrocarbons, liquefied petroleum gas, petroleum products, petrochemicals and electric power generation under the national energy industry.

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