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# The IFLR Guide to **M**exico

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In the energy sector, Mr Quintana has represented clients in various public and private projects, including independent power production, self-supply of power, cogeneration, financed works projects, natural gas distribution, and liquefied natural gas projects, among others. Recently, Mr Quintana acted as outside counsel for the energy transition team of President Vicente Fox.

Mr Quintana is a frequent speaker on panels discussing energy and Mexican law, and has published several articles on energy. He is the Vice President of the Mexican Power Association, and a member of the Mexican Bar, the Mexican Academy of Energy Law, and of the Ministry of Energy's Sub-Commission for Cogeneration.

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# The legal framework for energy in Mexico

By Miguel Angel Quintana of Thacher Proffitt & Wood, SC

## Introduction

As a country rich in natural resources, including some of the largest oil reserves in the world, Mexico has a long tradition in the energy sector. During the last century, the oil and power industry went from private control to governmental control, first with the nationalization of the oil industry in 1938 and subsequently with the nationalization of the power industry in 1960. At present, both Petróleos Mexicanos (Pemex) and its subsidiaries, that together are in charge of the oil industry, and Comisión Federal de Electricidad (CFE – the Mexican government-owned utility), are among the biggest companies in their respective fields in the world.

Although most of the activities related to the oil and power industries are under government control, the current legal framework gives room for private investment to carry out energy-related activities.

Despite the evolution of energy policies and the legal framework in Mexico over the last decade, additional changes are still required to boost the growth of the energy sector and, consequently, Mexican industry as a whole. The current administration will have to deal with the reorganization of the electricity sector – a vital move – and possibly the petrochemical industry too. Regarding oil, the ownership and control of the oil industry by the Government continues to be an important nationalistic-political flag, and the date on which private investment will be able to explore and exploit it again remains to be seen.

## Regulatory entities

### Ministry of Energy

The Ministry of Energy is in charge of the following activities (among other things):

- conducting the country's energy policy;
- exercising Mexico's rights regarding oil and all hydrocarbons, nuclear energy, and the resources required to generate, conduct, transform, distribute and supply power for public service; and
- carrying out medium- and long-term planning of the energy sector, and setting forth economic and social guidelines for the decentralized energy sector.

## Energy Regulatory Commission

The Energy Regulatory Commission (CRE) – an administrative but autonomous unit of the Ministry of Energy – has the following authorities (among other things):

- granting permits for power and natural gas-related activities that private entities and individuals may carry out;
- approving model agreements for interconnection, wheeling and back-up services when such services are to be provided by CFE and Luz y Fuerza del Centro (LFC); and
- approving regulations regarding pricing for acquisitions of power for public services; pricing for wheeling, transformation and delivery of power; first-hand sales of natural gas and LP gas; and the transportation, storage and distribution of natural gas and LP gas, and its pricing.

## Oil

Based on Mexico's Constitution and energy legislation:

- Mexico has the direct ownership of oil and of all solid, liquid and gaseous hydrogen carbides (jointly "hydrocarbons");
- regarding oil and hydrocarbons, no concessions or contracts will be granted (nor shall subsist with those previously granted), and the Mexican nation will carry out the exploitation of such goods in accordance with substantive law; and
- the functions carried out by the Mexican state regarding oil, hydrocarbons and basic petrochemicals are considered as strategic activities, and do not constitute a monopoly.

Mexican legislation establishes that oil and hydrocarbons exclusively exploited by Mexico constitute the oil industry. The oil industry comprises:

- the exploration, exploitation, refinement, transportation, storage, distribution and first-hand sale of oil and its by-products obtained from refining;
- the exploration, exploitation, elaboration and first-hand sale of gas, as well as the essential transportation and storage required to interconnect its exploitation and elaboration; and
- the elaboration, transportation, storage, distribution and first-hand sale of oil and gas derivatives that may be used as basic industrial raw materials and that constitute the basic petrochemicals.

Further, the exploitation of the oil industry is carried out by Pemex and its subsidiaries.

## Oil and NAFTA

Consistent with the Mexican Constitution, NAFTA establishes that the Mexican state reserves to itself the following strategic activities, including investment and the provision of services in such activities:

- the exploration and exploitation of crude oil and natural gas; refining or processing crude oil and natural gas; and the production of artificial gas, basic petrochemicals, and their feedstocks and pipelines; and
- foreign trade; and the transportation, storage and distribution, up to and including first-hand sales of (i) crude oil, (ii) natural and artificial gas, (iii) goods covered by Chapter Six of NAFTA obtained from the refinement or processing of crude oil and natural gas, and (iv) basic petrochemicals.

Regarding import and export restrictions, NAFTA incorporates various provisions of the General Agreement on Tariffs and Trade (GATT) with respect to prohibitions or restrictions on trade in energy and basic petrochemical goods, subject to specific provisions of NAFTA. Regarding export taxes, no party to NAFTA may adopt or maintain any duty, tax or other charge on the export of any energy or basic petrochemical goods to the territory of another party, unless such duty, tax or charge is adopted or maintained on (i) exports of any such goods to the territory of all other parties, and (ii) any such goods when destined for domestic consumption.

Furthermore, to reserve foreign trade for itself, Mexico may restrict the granting of import and export licences for certain oil-related products.

### *Permitted economic activities*

Because of the exclusivity granted to Pemex and its subsidiaries over the oil industry, the participation of private entities in the industry is limited to those activities that may be carried out as a contractor of Pemex. In this regard, the legal framework establishes that Pemex and its subsidiaries are empowered to carry out any transaction directly or indirectly related to its corporate purpose, and that within the context of its corporate purpose, Pemex and its subsidiaries may enter into any type of acts, agreements and contracts with individuals or entities, and may subscribe to credit instruments.

Likewise, the Oil Works Regulations establish that all works related to the oil industry require previous governmental authorization, and that such authorization will only be granted to Pemex, provided that Pemex may contract services with private entities or individuals, and provided further that any penalty imposed on Pemex as a result of a default of the terms and conditions of the Oil Works Regulations shall be covered by the corresponding contractor, as agreed in the respective agreement.

Further, the Oil Works Regulations establish the following:

- oil refining must be carried out exclusively by Pemex;
- transportation through pipelines within Mexico of crude oil, refined and certain gas-related products must be carried out exclusively by Pemex. Railway, road and maritime transportation may be done by contractors in limited cases. Distribution within cities may be carried out by contractors;

- storage in oil fields and refining facilities must be done exclusively by Pemex; storage facilities for distribution (other than those located within refining facilities) may be operated by third parties; and
- distribution up to first-hand sales.

### **Foreign investment restrictions**

The Foreign Investment Law establishes that gasoline retail is an activity reserved for Mexican nationals (individuals or entities), and that foreign investment may not participate directly in such activity nor in Mexican corporations engaged in such activity, nor through trusts, contracts, partnerships or by-law agreements, pyramiding plans, or other mechanisms granting any control or equity, except through the “neutral investment” scheme.

Furthermore, a resolution from the National Commission of Foreign Investments (NCFI) is required for foreign investment participation in a percentage greater than 49% of the capital stock of a Mexican entity whose corporate purpose includes (i) the construction of pipelines for transporting petroleum and products derived therefrom, and (ii) the perforation of petroleum and gas wells.

### **Pemex and its subsidiaries**

Pemex and its subsidiaries are state-owned, decentralized entities with its own legal capacity and patrimony. Pemex is domiciled in Mexico City and its purpose is the central conduct and strategic management of all the activities that make up the oil industry.

#### *Subsidiaries*

The Pemex subsidiaries comprise the following entities:

- Pemex-Exploración y Producción (Pemex-Exploration and Production), whose corporate purpose is (i) the exploration and exploitation of oil and natural gas, and (ii) its transportation, storage in terminal facilities, and commercialization;
- Pemex-Refinación (Pemex Refining), whose corporate purpose is (i) to carry out refining industrial processes, (ii) to manufacture oil by-products and oil derivatives which may be used as basic industrial raw materials, and (iii) to store, transport, distribute and commercialize such by-products and derivatives;
- Pemex-Gas y Petroquímica Básica (Pemex Gas and Basic Petrochemical), whose corporate purpose is (i) the processing of natural, liquid and artificial gas, (ii) the storage, transportation, distribution and commercialization of such hydrocarbons as well as of those oil derivatives that may be used as basic industrial raw materials; and
- Pemex-Petroquímica (Pemex-Petrochemical), whose corporate purpose is (i) to carry out industrial petrochemical processes regarding products not considered basic petrochemicals, as well as (ii) their storage, distribution and commercialization.

In addition to the subsidiaries described above, Pemex has other subsidiaries including PMI Comercio Internacional, SA de CV, which, in turn, has its own subsidiaries (jointly PMI). Basically, PMI is in charge of selling Pemex’s and the

subsidiaries' products in the international markets (except for natural gas) and acquiring oil derivatives required by Pemex to satisfy domestic demand.

### **Dealing with Pemex and its subsidiaries**

When dealing with Pemex and its subsidiaries, the following issues must be considered among other things (for the purposes of this section, references to Pemex include the subsidiaries).

#### *Hydrocarbons ownership*

Pemex does not own the oil and hydrocarbon resources located within Mexican territory; Pemex is only in charge of its exploitation. The United Mexican States will always maintain inalienable and permanent ownership, as well as the control of oil and hydrocarbons.

#### *Pemex assets*

Regarding Pemex assets, the following has to be considered:

(a) certain Pemex assets are considered as the "federation's public domain assets" – such assets have the following characteristics, among other things:

- (i) inalienability (ie they cannot be sold);
- (ii) imprescriptibly (ie they do not lose their privileged status);
- (iii) they are not subject to actions of ejection ("acción reivindicatoria", eg action to obtain title), and actions regarding definitive or provisional possession;
- (iv) creation of liens on the assets can only take place following authorization from the Executive, when it is necessary to obtain better financing conditions for the works and services of the corresponding entity;
- (v) rights to use and enjoy public domain assets are limited to the specific conditions set forth in the applicable legislation and in the corresponding concession title;
- (vi) transfer of ownership shall only be made by presidential decree, provided that the asset will cease to be useful for the public service purpose;
- (vii) only the federal courts have the competence to hear civil, criminal, administrative and other procedures in connection with such assets; and

(b) no writ of execution nor attachment order (including attachment prior to judgment, attachment in aid of execution and execution of a final judgment) can be ordered by a Mexican court against the property of Pemex.

### *Pemex expenses*

Pemex expenditure and income are highly supervised and controlled by the Federal Government.

Expenditures derived from current expenditure, investment in assets, and financial investments, as well as liability payments derived from public debt and patrimonial liability carried out by Pemex (among other entities) constitute federal public expenditure.

The planning of federal public expenditures is based on the economic and social development national directives and plans made by the Ministry of Finance and Public Credit (Ministry of Finance). In the case of Pemex, the Ministry of Energy is in charge of coordinating and evaluating, among other functions, the expenditure of Pemex and the entities under its sector (energy-related entities).

Once the Pemex budget is approved by its board of directors, and evaluated by the Ministries of Finance and Energy, the budget is included in the Federation Expenditure Budget which, in turn, has to be approved by the House of Representatives, and any contracting of debt will have to be approved by the Congress.

Generally, expenditure authorized in the Federation's Expenditure Budget for a given year will be paid for items that originate in that year. In exceptional and justifiable cases, the Ministry of Finance may authorize agreements in excess of the budget assignments for a given year, in which case the balance is to be paid in subsequent years, subject to budget availability in those subsequent years.

Long-term productive infrastructure programs ("Pidiregas") are investments made by entities like Pemex or CFE under direct budgetary control, financed with long-term private investment, to constitute income-oriented assets and whose budgetary impact is to vary in subsequent tax years.

A Pidiregas must be authorized by the Ministry of Finance and applies to productive infrastructure in priority activities; assets to be obtained from a Pidiregas project are intended to produce the income required to pay the financing. Until its final payment, the inclusion of a Pidiregas into the Federation Expenditure Budget has preference over financing projects contracted subsequently. Pidiregas programs are authorized based on a determination of their economic benefits (among other factors), and may adopt different legal schemes. The Federation Expenditure Budget shall include the Pidiregas programs authorized in previous and current tax years.

### *Pemex debt*

Direct or contingent liability obligations derived from financing transactions contracted by Pemex (among other entities) constitute public debt. Pemex shall only contract external financings following a previous authorization from the Ministry of Finance; domestic financings will be contracted with the previous authorization of the Pemex board of directors. Direct debt will be included in the Federation's Income Law and in the Federation's Expenditure Budget, and approved by Congress.

A Pidiregas program's payment obligations to be paid in a given year shall be considered as direct liabilities in such given year; payments to be made after that year shall be considered as contingent liabilities.

### *Sovereign guarantee*

Although not prohibited by law, the Federal Government generally does not guarantee Pemex obligations. However, Pemex and its subsidiaries may agree to be jointly or severally liable in connection with payment obligations derived from national or international transactions.

### *Pemex contracting*

Planning, programming, budgeting, contracting, expenditure, execution (in the case of public works), and control of public works, acquisitions and leases of non-movable goods and rendering of services of any nature when contracted by decentralized state entities like Pemex, are regulated by the Public Works Law and the Acquisitions Law.

As a general rule, Pemex contracts public works, public works-related services, acquisitions, leases and services through national or international public bidding. Exemptions include procedures of (i) invitation to at least three persons, or (ii) direct awarding.

Contractual penalties and penalty interest cannot be levied against Pemex in acquisitions, services and works agreements.

### *Payments*

Payments to be made by Pemex shall always be made in cash, and under no circumstances can percentages on the products or participations in the result of resource exploitation be granted. Further, obligations contracted in Mexico or abroad, to be paid in Mexico and in currencies other than Mexican pesos, may be fulfilled by payment in Mexican pesos at the exchange rate determined by Banco de Mexico (the Mexican Central Bank), on the place and date of payment.

### *Governing law and jurisdiction*

As a general rule, any act carried out by Pemex is governed by Mexican federal laws, and any legal action or proceeding in which Pemex is a party is submitted to the Mexican federal courts, although arbitration is permitted. Regarding international transactions, Pemex may agree to the application of a foreign law and to submission to a foreign jurisdiction (regarding actions of a mercantile nature), and the application of arbitration agreements.

### *Sovereign immunity*

In addition to (i) special rights granted to Pemex by legislation in legal proceedings in Mexico, which limit the ability to execute judgments against Pemex assets in Mexico (see above), and (ii) requirements to enforce a foreign judgment against Pemex, a judgment against Pemex by foreign courts may not be enforced based on the fact that the Mexican Government is a foreign sovereign and Pemex, as a decentralized entity of the Mexican Federal Government (and therefore owned by the latter), may plead sovereign immunity. Further, even if a judgment against Pemex may be obtained from a non-Mexican court, its enforceability may not be recognized and ordered by a Mexican court. Local counsel must be consulted regarding transactions with Pemex outside Mexico.

## Petrochemicals

Mexican legislation divides petrochemicals into basic and non-basic or secondary petrochemicals.

### Basic petrochemicals

Basic petrochemicals are the following products:

- ethane;
- propane;
- butane;
- pentane;
- hexane;
- heptane;
- raw material for smoke residuals;
- naftas; and
- methane, when of national origin and used as a raw material for petrochemical industrial processes.

Mexican legislation reserves to Pemex-Refinación and to Pemex-Gas y Petroquímica Básica the elaboration, transportation, storage, distribution and first-hand sale of oil and gas derivatives, which may be used as basic industrial raw materials and which constitute basic petrochemicals.

Obtaining basic petrochemical products from the elaboration of secondary petrochemicals – in which case the basic petrochemical products so obtained may be used in such production processes and within facilities of the same industrial unit or complex, or delivered to Pemex – constitutes an exception to the above.

### Secondary petrochemicals

The exploitation of such secondary petrochemicals (including their elaboration) may be carried out by private entities.

#### *Foreign investment considerations*

Foreign investment is permitted, without limitation, in the capital stock of Mexican entities that elaborate secondary petrochemicals, with the exception of those companies that supply fuels and lubricants to ships, airplanes and railways which are activities where foreign investment may participate in a percentage up to 49% of the capital stock of the Mexican entities that perform such activities.

### *Petrochemicals and NAFTA*

NAFTA includes dispositions that reserve to the Mexican state exclusivity over certain basic petrochemical-related activities (see above).

## Gas

### **Natural gas**

#### *Permitted activities*

**Transportation:** Transportation is defined as the activity of receiving, transporting and delivering gas through pipelines to those who are not final users within a geographic zone, and comprises the reception of gas at a transportation system point, and the delivery of a similar quantity at a different point of the same system.

Transportation permits are granted for a specific capacity and route, at the request of a petitioner or through public bidding. These permits may be for self-use or open access.

**Storage:** Storage is defined as the activity of receiving, holding, and delivering natural gas at or to fixed facilities other than pipelines, and comprises the reception of gas in a storage system point, and the delivery, in one or more acts, of the same amount of gas, either at the same point or at another one.

Storage permits are granted for a specific location and capacity, and at the request of a petitioner. These permits may be for self-use or open access.

**Distribution:** Distribution is defined as the activity of receiving, transmitting, delivering and, if applicable, marketing natural gas through pipelines in a geographic zone, and comprises (i) the commercialization and delivery of gas by the distributor to an end-user within a geographic zone, or (ii) the reception of gas at the distribution system reception point(s), and the delivery of an equal amount at a different point within the same system.

Distribution permits are granted for a specific geographical zone determined by CRE, which generally refers to cities. Generally, the first distribution permit for a specific zone is granted through public bid; it grants to the permit-holder a 12-year term of exclusivity to build the distribution system, along with reception, conduct and delivery activities within the zone. Distribution permits do not grant exclusivity over the commercialization of natural gas in the zone. After the term of exclusivity has elapsed, distribution permits are granted at the request of a petitioner. Consumers located in a specific geographical zone may contract the supply of gas with suppliers other than the distributor for such a zone, in which case the latter will permit the former to access its system, subject to compensation (open access).

**Self-transportation and self-storage:** Transportation and storage to satisfy the needs of a petitioner are subject to a permit issued by CRE. A natural gas self-supply entity may be incorporated, in which case such entities shall only deliver gas to the entity's shareholders.

### *Pricing*

The first-hand sale of natural gas is an activity exclusively reserved to the Mexican state, carried out by Pemex. The maximum prices for first-hand sales of natural gas, as well as tariffs for natural gas regulated activities, are established in accordance with the guidelines issued by CRE.

### *Import and export of natural gas*

Subject to customs requirements, importation and exportation shall freely be made.

### *Permits*

A permit from the CRE must be obtained to carry out any of the natural gas permitted activities. Permits are granted for 30-year terms, renewable for 15-year periods. They are granted to public (Pemex) and private entities.

Although, as a general rule, the same entity may hold one or more permits for any of the natural gas permitted activities, the holding of transmission and distribution permits in the same geographical zone shall not be granted or transferred to the same company, nor to entities who directly or indirectly hold such permits or who have an interest in such permitted entities within the same geographical zone (vertical integration), unless CRE authorizes an exception, when, in its sole discretion:

- it results in improved efficiency gains and returns on investment with respect to the provision of services, but in no event may there be controlling interests between the transporter and the distributor; or
- such granting is strictly necessary because there is an absence of the transportation infrastructure required to develop a particular geographic zone, and there are no other parties interested in such transportation or distribution projects; this exception shall only be authorized for a 12-year exclusive period.

When a geographic zone is determined, and a transportation system delivery point is already in such a zone, the transporter may obtain the exclusive distribution permit for that zone through a bidding procedure. If the transporter obtains a distribution permit, it may hold both transportation and distribution permits during a 12-year exclusive period. If the transporter does not obtain the distribution permit, it may not extend or expand its system, and it may only provide services within the geographic zone during the term of the agreements executed with final users prior to the determination of the relevant geographic zone.

Permits may be:

- transferred with the previous authorization of CRE;
- encumbered to guarantee financing obligations directly related to the service, or to operational liabilities in which case a notice to CRE will have to be served, or for other purposes in which case the authorization from CRE will have to be obtained; and
- amended in accordance with guidelines issued by CRE.

Other dispositions in the NG Regulations include those related to renewal, expiration, partial expiration, early termination, service abandonment and revocation, among other things.

*Foreign investment considerations*

Foreign investment may freely participate in the capital stock of Mexican entities that carry out permitted activities.

**Liquefied petroleum gas**

*Permitted activities*

Transportation: Transportation is defined as the activity of receiving, transmitting and delivering liquefied petroleum gas (LPG) through:

- auto tanks, semi trailers, car tanks and ship tanks, in which case the transportation comprises the conduct of LPG between LPG deposit, distribution, supply and carburetion station facilities; or
- pipelines, in which case the transportation comprises the reception of LPG owned by a third party, at a particular point of the pipeline, and the conduct and delivery of a similar amount of LPG at a delivery point within the same pipeline or system.

Storage: Storage is defined as the activity of receiving and holding LPG through:

- a deposit storage facility, in which case the storage comprises the activity of receiving LPG in a deposit storage facility, and its holding and subsequent devolution to the depositor in the same facility; or
- a supply facility, in which case the storage comprises the holding of LPG in such a facility for its sale to third parties.

Distribution: Distribution is defined as the activity of receiving, conducting, storing and deliving LPG to end-users, provided that:

- distribution through distribution storage facilities comprises the purchase and storage of LPG to be sold to end-users or to carburation LPG stations;
- distribution for carburetion has, as a purpose, the selling of LPG only to carburetion stations, for its use in internal combustion engines vehicles; and
- distribution through pipelines comprises the purchase, conduct, delivery and commercialization of LPG through distribution networks for end-users.

Self-transportation and self-storage: Transportation through pipelines and storage in carburetion LPG stations to satisfy the needs of a petitioner are subject to a permit issued by the Ministry of Energy.

### *Pricing*

The maximum prices of first-hand sales of LPG are established in accordance with guidelines issued by CRE.

### *Import and export of LPG*

Importation and exportation shall freely be made, subject to customs requirements.

### *Permitting*

A permit from the Ministry of Energy or CRE, as the case may be, must be obtained to carry out any of the LPG permitted activities. Permits are granted for 30-year terms, subject to renewal. Permits for transportation and storage are granted to public (Pemex) and private entities; permits for distribution are granted to Mexican entities and individuals.

CRE is in charge of granting permits for the transportation and distribution of LPG through pipelines. Permits for storage and other forms of transportation and distribution of LPG are granted by the Ministry of Energy.

Although, as a general rule, the same entity may hold one or more permits for any LPG permitted activities, the holder of a pipeline transmission permit shall not be the holder, directly or indirectly through affiliates or subsidiaries, of another permit, nor may it participate in the rendering of other LPG permitted activities. This restriction also applies to entities or individuals that participate as shareholders in such a transporter (vertical integration).

Permits may be transferred subject to previous authorization from the Ministry of Energy or CRE, as applicable. Other dispositions in the LPG Regulations include those related to renewal, expiry and revocation, among other things.

## **Foreign investment considerations**

LPG distribution is an activity reserved to Mexican nationals, and foreign investors may not participate directly in such activity, nor in Mexican corporations engaged in the same activity, nor through trusts, contracts, partnerships or by-law agreements, pyramiding plans, or other mechanisms granting any control or equity, except through a “neutral investment” scheme.

Foreign investors may freely participate in transportation and storage activities.

## **Liquefied natural gas**

Legislation regarding liquefied natural gas (LNG) facilities and activities is due to be in force by the end of 2001 in the form of amendments to the NG Regulations, and the issuance of official norms and directives. Current legislation mainly refers to vehicles that consume LNG and LNG stations for such vehicles.

## Electricity

The review of the electricity legislation that follows is based on the relevant legislation in force as of August 2001. It is important to be aware of the possibility of changes, which may result in some of the items described below no longer applying in the near future. In any case, Mexican counsel will have to be consulted to confirm applicability, revocation and/or the enactment of new legislation.

The Constitution, NAFTA and the power regulatory legislation sets forth:

- Mexico's exclusive right to generate, conduct, transform, distribute and supply electricity that is to be used for public service;
- that no concessions shall be granted regarding such public service; and
- that the functions carried out by the state regarding such public service are considered as strategic activities and do not constitute a monopoly.

Public service activities are carried out exclusively by CFE and LFC, the two government-owned utilities. The dispatch and operation of the national electric system (grid) is controlled by the National Center for the Control of Energy (CENACE), which depends on CFE.

### Permitted activities

The activities that are not considered public service activities, and that therefore may be carried out by private entities, are the following:

- (a) power generation through any of the following schemes:
  - (i) self-supply;
  - (ii) cogeneration, either for self-consumption or to export power;
  - (iii) small-scale production for self-consumption, to sell power to CFE, or to export it;
  - (iv) independent power production, either to sell power to CFE, or to export it;
  - (v) generation of power for interruptions of service; and
- (b) importation of power for self-consumption.

### *Self-supply*

Under the self-supply scheme, the takers may be co-owners of power generation facilities or they may organize corporations that will own and operate a power facility.

Electricity generated by self-supply power facilities may only be consumed by its co-owners or by shareholders of the corporation that own the self-supply facility, as the case may be, provided, however, that surpluses of electricity may be sold only to CFE/LFC.

Other entities such as developers, EPC or O&M contractors may be shareholders of the corporation that produces the electricity, even though they do not consume electricity generated by the corresponding facility. As a general rule, changes in the identity of shareholders/power consumers may be authorized through a fast-track process, if such changes were contemplated in a corresponding expansion plan when the permit was requested; if such changes were not contemplated, the authorization of the CRE will have to be obtained.

### *Cogeneration*

Cogeneration is defined as:

- the production of electricity together with steam or other forms of secondary thermal energy, or both;
- the direct or indirect production of electricity from thermal energy not used in industrial processes that originate cogeneration; and
- the direct or indirect production of electricity using fuels produced in industrial processes that originate cogeneration.

Electricity generated by a cogeneration facility shall be destined to satisfy the needs of individuals or corporations that use or produce steam, thermal energy or fuels that originate cogeneration processes, or that are co-owners of facilities or shareholders of corporations that own the cogeneration facility.

Other entities such as developers, EPC or O&M contractors may be shareholders of the corporation that carry out the cogeneration process even though they do not consume electricity generated by the cogeneration facility.

### *Independent power production*

An independent power producer (IPP) is a power producer that owns a facility with a capacity greater than 30 MW, and whose production is exclusively destined to CFE or to exportation.

Sales of capacity and electricity may be made to CFE through long-term agreements. Generally, sales to CFE are derived from public bids, except in the case of emergencies that may jeopardize the supply of power to the entire Mexican republic or to a particular region.

Public bids for long-term power purchase agreements are called by CFE under the rules of the Electricity Regulations, which set forth the general terms and conditions that the bid calls and the bid guidelines must contain, the steps to

be followed regarding the evaluation of the bid proposals and the execution of the power purchase agreements, and the minimum requirements of such agreements. Power purchase agreements are awarded to the contractor that offers a solvent offer, that fulfils all the requirements of the bid guidelines and that guarantees the corresponding obligations. If two or more offers satisfy all the requirements, the agreement will be awarded to the lower long-term economic power cost offer.

#### *Small-scale production*

A small producer of power is a producer that owns a facility with a capacity that is no greater than 30 MW, and whose production is exclusively destined for CFE or exportation. Self-supply of 1 megawatts or less to small rural communities or isolated areas is also considered as small-scale production.

A small producer permit holder may make sales of capacity and electricity to CFE. As with IPPs, sales to CFE are derived from public bids except in emergencies that may jeopardize the supply of power to the entire Mexican republic or to a particular region.

#### *Generation of power for interruptions of service*

The operation of power plants to be used in emergencies, regardless of their capacity, does not require a previous permit from CRE.

#### *Importation of power*

Importation of power shall only be authorized for self-consumption.

#### *Permits*

A permit from the CRE must be obtained in advance to carry self-supply (except for projects that do not exceed 0.5 megawatts, other than those related to small rural communities or isolated areas), cogeneration, IPPs, small production, importation and exportation of power.

All permits shall have an indefinite term, except for IPP permits that cannot exceed 30 years (subject to renewal). In the case of IPPs and small production projects, the corresponding permits must be granted only to Mexican individuals or corporations domiciled in Mexico. The previous authorization of the CRE must be obtained to generate power in different conditions to those established in the corresponding permit.

The Electricity Regulations establish the rules regarding the application, granting (generally a permit must be obtained in approximately three months), renewal (in the case of IPPs), transfer and ending of permits, as well as the permit holder obligations.

#### *Foreign investment considerations*

Foreign investment may freely participate in the capital stock of entities that carry out permitted activities.

## **CFE/LFC**

Like Pemex, both CFE and LFC are state-owned, decentralized entities, having their own legal capacity and patrimony.

CFE is the main producer of power in Mexico; most of the transmission belongs to CFE. Regarding distribution, CFE is in charge of public services across the country, except Mexico City and part of the states of Mexico, Morelos, Hidalgo and Puebla, which are served by LFC.

## **Dealing with CFE/LFC**

CFE/LFC follows the same treatment as described in the “Pemex assets”, “Pemex expenses”, “Pemex debt”, “Pemex contracting”, “Governing law and jurisdiction”, “Sovereign guarantee”, and “Sovereign immunity” sections above. Regarding payments, although there is no specific restriction on making payments in kind (such as the restriction imposed on Pemex and its subsidiaries), as a general rule, CFE/LFC make payments in cash. However, under certain circumstances, CFE/LFC may pay its obligations with power (kw/h).

## **Surplus power**

Permit holders may sell surplus power (sales outside public bids that are not emergencies) to CFE. CFE may enter into agreements with self-supply and cogeneration permit holders with whom – subject to dispatch rules and pricing methodologies to be issued – capacity payments as well as energy payments shall be agreed, in accordance with the following:

- up to 20 MW regarding self-supply permit holders, as long as the same have an installed capacity of up to 40 MW;
- regarding self-supply permit holders, up to 50% of their total capacity as long as such permit holders have a total installed capacity greater than 40 MW; this percentage may be amended taking into account public service requirements and the level of the national electric system energy reserves; and
- regarding cogeneration permit holders, up to their total surplus production.

## **Interconnection, wheeling, and back-up power**

Private entities may use CFE lines or they may build their own. Interconnection, wheeling, and back-up power are services granted by CFE/LFC in accordance with official model agreements and tariffs approved by CRE.

Private entities may construct, operate and maintain the transmission lines they require, as long as such lines are not interconnected to the public service network and they comply with Mexican official standards.

Transmission lines connected to the national network may be transferred to CFE/LFC from the interconnection point in accordance with the Contributions Regulations.

There is no specific permit required by CRE to build and operate transmission lines. The authorization comes within the terms and conditions of permits for self-supply, cogeneration, IPP, etc.

## Nuclear energy

Pursuant to the Constitution and the energy regulatory legislation:

- ownership of radioactive minerals and nuclear fuels belongs to Mexico;
- regarding radioactive minerals, no concessions or contracts will be granted, and Mexico will carry out its own exploration, exploitation and benefit, as well as the exploitation of nuclear fuels to generate nuclear energy;
- use of nuclear energy shall only have peaceful purposes; and
- functions carried out by the Mexican state regarding radioactive minerals and nuclear energy are considered to be strategic activities, and do not constitute a monopoly.

Likewise, NAFTA includes dispositions that reserve exclusivity over nuclear power activities to the Mexican state.

The use of nuclear reactors for purposes other than to generate electricity can only be carried out by the Mexican Government and by universities, institutes and research centres that are duly authorized. Following the issuance of a permit from the Ministry of Energy, private entities may produce, use and apply radioisotopes, as well as manufacture components for the supply of steam nuclear systems, with the exception of nuclear fuel.