

**SOME CONSIDERATIONS ON THE NEW FOREIGN
INVESTMENT POSSIBILITIES IN THE MEXICAN OIL AND
GAS INDUSTRY**

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By

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PREFACE

The MEXICAN LAW LIBRARY is update twice annually, through June 30 and December 31 of each year. There were no amendments promulgated to the laws reported in this volume through June 30, 1997.

However, as a result of significant changes occurring in Mexico's oil and gas industry, due in large part to the new Natural Gas Regulations and amendments to the Regulatory Law to Article 27 of the Constitution in the Petroleum Sector, both contained in the original volume, it is appropriate to present in this pocket part the article, "Some Considerations on the New Foreign Investment Possibilities in the Mexican Oil and Gas Industry," written by Alejandro López Velarde of the Mexico City office of the law firm of LOPEZ VELARDE, WILSON, ABOGADOS, S.C.

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Amendments from January 1, 1997, until
June 30, 1997.

None.

SOME CONSIDERATIONS ON THE NEW FOREIGN INVESTMENT POSSIBILITIES IN THE MEXICAN OIL AND GAS INDUSTRY

**Written in Spanish and English by:
Alejandro López-Velarde¹**

I. INTRODUCTION

Over the years, Mexican foreign investment policy has carefully limited foreign investment in sectors of the economy which have had political, historic, and economic significance for the country. During the last decade, however, Mexican policy in key sectors such as energy, transportation and telecommunications has responded to the requirements of sustainable national economic development by adopting a more open approach to foreign investment in areas previously subject to substantial restrictions. Current Mexican international economic policy and the successfully negotiated North American Free Trade Agreement (“NAFTA”)² have led to sweeping changes in both domestic economic and foreign investment policies.

The most recent example of this liberalization has been the modifications and reforms made to the Mexican energy sector. On May 11, 1995, the Regulatory Law to Article 27 of the Mexican Constitution in the Petroleum Sector (the “Petroleum Law”) was enacted.³ The approval of these modifications and reforms to the Petroleum Law represents a historic break with the past. Today, the Petroleum Law allows for private investment in the natural gas sector of Petróleos Mexicanos (“Pemex”) Foreign activity in this sector may be procured through the Comisión Reguladora de Energía (Energy Regulation Commission) Known by its Spanish acronym of “CRE”, and may encompass direct investment, transport, storage and distribution of natural gas.

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² Decreto de Promulgación del Tratado de Libre Comercio de América del Norte (Promulgation Decree of the North American Free Trade Agreement) [hereinafter cited as “NAFTA”] published in the Diario Oficial [Hereinafter cited as “D.O.”] Dec. 20, 1993.

³ *See*, Mex. Ley Reglamentaria del Artículo 27 Constitucional en el Ramo del Petróleo (Petroleum Provisions of the Regulatory Law of Article 27 of the Mexican Constitution) [hereinafter cited as the “Petroleum Law”, *published* in D.O. Nov. 29, 1958 *amended* in D.O., May 22, 1995.

1. Historical Background

Traditionally, the oil and gas industry has been a symbol of Mexican sovereignty. This mid-set dates back to the administration of Porfirio Diaz, when Mexico's mineral and petroleum resources were controlled by foreign interests. Domestic controls and regulation of these foreign interests were nearly non-existent during the Porfiriato. However, succeeding administrations set out to limit foreign participation in the oil and gas sector. In order to carry out this objective, politicians enacted a new Constitution in 1917. One of the primary purposes of this supreme law was the implementation of strict controls over rampant investment, an intent embodied throughout the Constitution, especially Articles 27 and 28.⁴

The full significance of Article 27 was not felt until 1938 when president Lazaro Cardenas expropriate private property interests throughout Mexico, including the oil and gas industry.⁵

However, it was not during Cardenas administration that the national monopoly was placed into full effect. Instead, one of the largest present day monopolies in the petroleum sector was created during the administration of President Ruiz Cortines, a monopoly created by the promulgation of a new Petroleum Law.⁶ This monopolistic stronghold was strengthened with the enactment of the Regulation of the Petroleum Law in 1959, during the administration of President Adolfo Lopez Mateos.⁷

⁴ *See*, Mex. Constitución Política de los Estados Unidos Mexicanos, (Political Constitution of the United Mexican States) [hereinafter cited as "Const."], published in D.O., Feb. 5, 1917, Arts. 27-28. Art. 27 is a complex provision, directed toward defining the limitations of foreign interests in different strategic areas of the Mexican economy. However, Article 27 was not fully employed between 1917 and 1923. Foreign interests were mostly unaffected by the new Constitution, and mining and oil interests continued an unfettered increase in production. When problems arose after World War I, and the subsequent world recession, oil production dropped significantly. At this point, President Alvaro Obregón planned the retroactive application of Art. 27 to foreign-owned oil companies. Concern on the part of these investors led to tensions and conflict between the investors and the State. However, due to vast lobbying on the part of the investors, Obregón finally agreed to respect existing concessions. After this initial effort to impose these strict Constitutional regulations, Mexico and its investors continued a relentless period of high volatility and tension that lasted nearly fifteen years.

⁵ The expropriation was an act of sovereignty that culminated in the nationalization process of the oil and gas industry. Such nationalization began with the demands of the petroleum workers, who had called for proper working conditions and decent wages. Such demands were based on a favorable labor award to which the foreign companies refused to abide. For a complete understanding of the expropriation of the oil and gas industry *see Gobierno de México, "LA VERDAD SOBRE LA EXPROPIACION DE LOS BIENES DE LAS EMPRESAS PETROLERAS" (THE TRUTH AS TO THE EXPROPRIATION OF THE ASSETS BELONGING TO THE PETROLEUM INDUSTRY)* 11-263 (Talleres Gráficos de la Nación 1940).

⁶ *See*, Petroleum Law, *supra* note 3.

⁷ *See* Mex. Reglamento de la Ley Reglamentaria del Artículo 27 Constitucional en el Ramo del Petróleo (Regulation of the Petroleum Provisions of the Regulatory Law of Article 27 of the Mexican Constitution) [hereinafter referred as to the "Regulation of the Petroleum Law", *published* in D.O. Aug. 25, 1959.

The possibility of private participation in the natural gas sector was not re-contemplated until 1994 during the final year of the Carlos Salinas administration.⁸ The major impetus behind this proposal was the desire to increase production of domestic natural gas, reduce Mexico's reliance on natural gas imported from the United States, while still providing enough of this resource for domestic consumption. A plan for private participation gained momentum because Mexico has been unable to develop the natural gas industry on its own, because of poor pipeline and distribution infrastructure, environmental concerns and lack of financial resources, particularly in the northern regions of the country.

The current administration of president Ernesto Zedillo has privatized the natural gas sector and disincorporated Pemex's secondary petrochemical assets. Needless to say, such decision is a very important step in the liberalization of the Mexican economy. However, due to the historical tie between oil and sovereignty, the current administration has encountered some problems in the privatization of the secondary petrochemical industry.⁹

II. GENERAL LEGAL FRAMEWORK OF THE OIL AND GAS INDUSTRY.

2. Legal Ordinances Applicable to the Oil and Gas Industry

To understand the legal regime behind the Mexican oil and gas industry, it is necessary to consider a variety of existing legal ordinances. The most important legal ordinances applicable to this sector are described below according the hierarchical order established in the supremacy clause of the Mexican Constitution: (i) the Mexican Constitution;¹⁰ (ii) the Petroleum Law; (iii) the Organic Act of Petr leos Mexicanos and Subsidiary Entities and its Regulation (the "Pemex Charter"); (iv) the Foreign Investment Law ("FIL"); (v) the Regulations to the Regulatory Law to Article 27 of the Mexican Constitution in the Petroleum Sector (the "Regulation to the Petroleum Law"); (vi) the Regulations to the Regulatory Law to Article 27 of the Mexican Constitution in the Petrochemical Sector (the "Petrochemical Regulation"); (vii) the Natural Gas Regulation; (viii) the Regulation of Distribution of Liquefied Natural Gas (the "LPG Regulation"); and (ix) the Resolutions issued by the Ministry of Energy which classified products in basic and secondary petrochemicals.

⁸ The 1959-1994 National Development Plan (*see* Mex. Plan Nacional de Desarrollo 1989-1994, *published* in D.O. May 31, 1989) and the Program for Energy Modernization (*see* Mex. Programa Nacional de Modernizaci n Energ tica 1990-1994, *published* in D.O. May 7, 1990) established the general objectives and priorities that the federal public administration must follow in order to accelerate Pemex' transformation to meet the growing requirements of the national market.

⁹ decisions: (1) opposition to foreign domination; (2) government revenues; and (3) price subsidies" *see* Gary B. Conine, Natural Gas Transactions Between the United States in Mexico; Political and Legal Impediments to Free Trade, 27 Tex. Intl. L.J.577, 594, (1992).

¹⁰ Article 133 establishes that "(The Mexican Constitution), the Law of the Congress of the Union which emanate therefrom, and all treaties made, or which shall be made in accordance therewith, by the President of the Republic, with the approval of the Senate, shall be the Supreme Law throughout the Union. The judges of each State shall conform to said Constitution, the law, and treaties, notwithstanding any contradictory provisions that may appear in the Constitution or laws of the States" *See* Const. *supra* note 4, Art. 133.

2.1 Organic Act of Pemex and Subsidiary Entities

Pemex was created by the Mexican congress via decree, immediately after the expropriation of the oil and gas industry¹¹. Subsequently, Pemex took control of and administered the assets expropriated from the foreign owners. Today, Pemex and its subsidiaries are decentralized public entities of the federal Mexican government, entrusted by the Nation to carry out the oil and gas industry.¹²

Pursuant to Mexican administrative law, Pemex and its subsidiaries do not have capital stock, stated capital or title of ownership. Instead, Pemex and its subsidiaries have independent legal status created for the purpose of managing and providing long-range planning for all activities related to the Mexican's petroleum industry in accordance with the terms of the Petroleum Law.¹³ Foreign participation in Pemex or in its subsidiaries is completely prohibited.

Pemex and its subsidiaries are in charge of both upstream and downstream activities. The present administration is attempting to allow private participation in the downstream sector according to the Constitution so that Pemex can devote its revenues to exploration and exploitation activities.

Throughout the years, Pemex has expanded its scope of activities to include a variety of economic activities that were not categorized as strategic areas constitutionally reserved to the Nation and reserved for the oil and gas industry in the Petroleum Law. The Mexican government in 1992 submitted bill to the Mexican congress which restructures Pemex in order to guarantee its role in the Mexican economy and the international market. Upon approval of the bill, the Pemex Charter changed the structure of the operative subdirections of Pemex Charter changed the structure of the operative subdirections of Pemex into subsidiaries thereby creating: (i) Pemex-Exploration and Production ("Pemex-E & P");¹⁴ (ii) Pemex-Refining;¹⁵ (iii) Pemex-Gas and Basic Petrochemicals ("Pemex-G & BP"),¹⁶ and (iv) Pemex-Petrochemicals.¹⁷

¹¹ *See* Mex. Decreto que Crea la Institución Petróleos Mexicanos (Decree that Creates the Petróleos Mexicanos Institution), *published* in D.O. June 7, 1938, Art. 3. *See* also the Petroleum Law, *supra* note 3, Art. 4; Ley Orgánica de Petróleos Mexicanos y Organismos Subsidiarios (Organic Act of Petróleos Mexicanos and Subsidiary Entity) [hereinafter cited as the "Pemex Charter"], *published* in D.O.

¹² *See* Const. *supra* note 4, Arts. 27-28; Pemex Charter, *supra* note 11, Art. 1; Petroleum Law, *supra* note 3, Art.4.

¹³ *See* Mex. Ley Orgánica de la Administración Pública Federal (Organic Law of the Federal Public Administration) [hereinafter referred as to "LOAPF"], *published* in D.O. Dec. 29, 1976, Art. 45; Ley Federal de Entidades Paraestatales (Federal Law on Paraestatal Entities), *published* in D.O. May 14, 1986, Arts. 6, 14 (I); Pemex Charter, *supra* note 11, Art. 2.

¹⁴ The E & P subsidiary is exclusively entrusted with the development of the exploration and operations of petroleum and natural gas, as well as their transportation, storage, and marketing. *See* Pemex Charter, *supra* note 11, Art. 3 (I). Regarding the assignment of lands to this subsidiary for exploration and exploitation purposes, Petroleum Law, *supra* note 3, Art. 5. Pemex-E & P carries out its activities through its own infrastructure or by executing service contracts with private corporations.

¹⁵ The refining subsidiary is in charge of the manufacture of the petroleum products and by-products that may be used as basic industrial raw materials, as well as storage, transportation, distribution and marketing of the same. *See* Pemex Charter, *supra* note 11, Art. 3 (II).

¹⁶ The G & BP subsidiary processes natural gas, liquefied natural gas, and synthetic gas; storage, transportation, distribution, and marketing of these hydrocarbons and the by-products that may be used as basic industrial raw materials. *Id.* Art. 3 (III).

Such subsidiaries enjoy independent legal status with capacity to own property, and are independently responsible for the functions entrusted to them. They are structured along integrated lines of business and operate as cost centers which are evaluated based on their own productivity. At the same time Pemex-Corporativo remains the entity primarily responsible for the oil and gas industry.

2.2 The Mexican Constitution

As previously stated, the Constitution is the most important legal ordinance addressing the oil and gas industry, Pursuant to this supreme law the Nation has direct dominion over the subsoil as well as the exclusive right of exploitation and development of petroleum and gas. The wording of the Constitution prohibits the private ownership of hydrocarbons and reserves ownership of petroleum and all solid, liquid, and gaseous hydrocarbons to the State.¹⁸ The ownership of such natural resources is a Constitutional right that is inalienable and imprescriptible.¹⁹ Therefore, it is not possible for the State to concede oil exploration and exploitation rights to private parties. In addition, in 1983, Article 28 of the Constitution was modified to include the so-called *strategic areas*, among which all domestic hydrocarbon resources and basic petrochemical are deemed to be strategic activities which are exclusively reserved to the State.²⁰ Private participation, either national or foreign, is clearly prohibited.

2.3 The Petroleum Law

In 1958, the Constitutional provisions referenced above were broadly interpreted by the Congress through the promulgation of the Petroleum Law. The original version of the Petroleum Law broadened the activities reserved for the oil and gas industry.²¹ However, the modifications and reforms of the Petroleum Law, enacted May 11, 1996, allowed domestic and foreign private sectors to participate in the transportation, distribution and storage of natural gas,²² thereby taking the first step in the decentralization of one of the largest state oil and gas monopolies. Pursuant to these modifications, the petroleum industry currently encompasses (i) the exploration, exploitation, refining, transportation, storage, distribution and first-hand sale of petroleum, and its by-products obtained through the refining process; (ii) the exploration, exploitation, production, and first hand sale of gas; and (iii) production, storage, transportation, distribution, and first-hand sale of by-products that can be used as basic industrial materials, as well as those gases that are considered basic petrochemicals.²³ Thus all the phases of the oil and gas industry have been exclusively reserved to the Mexican government which develops the petroleum industry through Pemex, with the exception of the storage, transportation and distribution of natural gas.

¹⁷ The Petrochemical subsidiary develops the processing of products that are not part of the basic petrochemical industry, as well as the storage, distribution and marketing of such products. *Id.* Art. 3 (IV).

¹⁸ *See*, Const., Art. 27, *supra* note 4.

¹⁹ *Id.* Art. 27. *See* also, Petroleum Law, *supra* note 3, Art. 1.

²⁰ *Id.* Art. 27. *See* also, Petroleum Law, *supra* note 3, Art. 1.

²¹ In fact, the 1940 Petroleum Law established that this industry covered only the discovery, harnessing, conveyance through pipelines, and refining of petroleum. One year later, this industry was broadened even more by the 1941 Petroleum Law which included the exploration, exploitation, transportation, storage, refining, and distribution of petroleum, and the manufacturing and distribution of synthetic gas.

²² The Congressional modifications and reforms to the Petroleum Law entered into force on May 12, 1995. *See* Petroleum Law *supra* note 3, Art. 1 transitory.

²³ *Id.* Art. 3.

2.3.1 Modifications and Reforms to the Petroleum Law

The Petroleum Law's modifications and reforms were enacted in full accord with the Constitution and established very broad legal principles. This congressional reform allows the federal executive to address the intricacies of the Petroleum Law in its Regulation, thereby permitting the executive office to change the current structure of the petroleum regime through the creation of a more detailed body of law.²⁴

The participation of the private sector will be carried out under the following conditions and restrictions:

1. Pemex's present transportation pipelines are not for sale;²⁵
2. Pemex maintains control over domestic natural gas, (i) exploration and exploitation; (ii) refining; (iii) first-hand sale. In turn, foreign and domestic private investors can participate in the gas industry in terms of (i) operation of pipelines; (ii) transportation; (iii) distribution; and, (iv) storage;²⁶
3. By, analyzing the Petroleum Law, in conjunction with the Foreign Investment Law of 1993 ("FIL"),²⁷ we can deduce that foreign companies can now engage in the above-mentioned activities. Specifically, investing companies may now operate and own natural gas pipelines, installations and related facilities as well as develop the storage, transportation and distribution of natural gas activities in Mexico, with a participation of up to 100 percent;²⁸

²⁴ Part of the Mexican doctrine considers that this kind of modifications and reforms, through which the Executive Branch and Mexican Congress establish very broad legal principles so that the Federal Executive may establish the term and conditions under which private investors may participate with Pemex in the natural gas sector through regulations is a violation of the Mexican legal system. According to the Constitution, the Mexican President is empowered to provide Regulations for the application and understanding of a Congressional law. However, the President can not use the Regulations to legislate, as appears to be the case with the Petroleum Law modifications. *See* Const. *supra* note 4, Art. 89 (I).

²⁵ *See* Petroleum Law, *supra* note 3, Arts. 4, 3, transitory.

²⁶ *Id.* Arts. 3-4.

²⁷ *See* Mex. Ley de Inversiones Extranjeras (Foreign Investments Law) (hereinafter cited as "FIL").

²⁸ One of the most important changes made by the Mexican Congress regarding foreign investment was not to consider the 49%-foreign, 51%-domestic investment general rule contemplated by its predecessor, the Law to Promote Mexican Investment and to Regulate Foreign Investment (the "1973 FIL"). Article 5 of the 1973 FIL dictated that in cases where legal provisions or regulations do not specify a given percentage, foreign investment may hold no more than 49% of the capital of corporations provided it is not empowered, by any title, to determine the management of the corporation. (*See* Mex. Ley para Promover la Inversión Mexicana y Regular la Inversión Extranjera (Law to Promote Mexican Investment and to Regulate Foreign Investment) [hereinafter cited as the "1973 FIL"], published in D.O. Mar. 9, 1973, Art. 5). For a better discussion and analysis of the 1973 FIL *see* Ewell E. Murphy, Jr., *The Echevarrian Wall: Two Perspectives on Foreign Investment and Licensing in Mexico*, 17 Tex. Intl. L.J. 135, 137-139, 148-149 (1982). For a practical analysis of the new FIL *See* Alejandro Lopez-Velarde, *Some Considerations as to the New Mexican Foreign Investment Law*, 10 News. Of the Intl. Secc (State Bar of Tex.) 27-42 (Feb. 1994).

4. Foreign investment in the construction of pipelines is limited to 49 percent. Nevertheless, such limitation can be overcome by the favorable resolution of the Foreign Investment Commission, who may authorize foreign investment in excess of the prescribed percentage;²⁹
5. Permits for private participation will be issued from the CRE;³⁰ and
6. Permit holders will be allowed to provide gas transportation and distribution services to third parties.³¹

2.3.2 Policies Behind the Modifications

The principal policies behind the modifications and reforms to the Petroleum Law include (i) lack of financial resources that can be dedicated to the modernization of the natural gas industry (this is particularly true in the northern region of the country where Mexico intends to explore for and exploit dry gas); (ii) lack of an adequate distribution infrastructure;³² (iii) uncertainty in the supply of natural gas to petrochemical and thermoelectrical plants, as well as other consumers that might require this fuel for industrial purposes; (iv) the need to meet domestic demand and thereby limit the need to import natural gas from Texas, and other U.S. border states; and (v) development of the natural gas industry in order to allow Mexico to export natural gas.

2.4 The Foreign Investment Law (“FIL”)

2.4.1 Economic Activities

In addition to the natural gas provisions specified above, the new FIL is in complete accord with the present legal framework of the oil and gas industry. In this manner, the FIL:

- (i) ratifies that petroleum and other hydrocarbons, as well as the basic petrochemical industries, are reserved to the Mexican State;³³

²⁹ *See* FIL, *supra* note 27, Art. 8 (X). The pipeline construction activity is considered a public utility activity. *See* Petroleum Law, *supra* note 3, Art. 10.

³⁰ *See* Mex. Reglamento de Gas Natural (Natural Gas Regulation) [hereinafter cited as the “Gas Regulation”], *published* in D.O. Nov. 8, 1995, Art. A4. *See* also Mex. Ley de la Comisión Reguladora de Energía (Energy Regulation Commission Law) [hereinafter cited as “CRE Law”] *published* in D.O. Oct. 31, 1995, Arts. 2 (VI)-(VII), 3 (XII).

³¹ *See* Petroleum Law, *supra* note 3, Art. 10.

³² Pemex is the largest and most important taxpayer in Mexico. This entity contributes more to the reduction of the public deficit than any other entity. For instance, during the first quarter of 1996, the total tax paid by Pemex was \$35,482 million pesos. This amount constituted 68% of Pemex’s total sales for the same period. We can therefore note that most of Pemex’s revenue goes directly to the Mexican Treasury, and leaves very few profits for re-investment in activities such as exploration, exploitation and maintenance. *See* Gabriela Amador, Crecieron 26% las Utilidades de Operación de Pemex (Pemex Production Revenue was increased 26%), *El Economista*, *See* Industry and Commerce, 32 (May 3, 1996).

³³ *See* FIL, *supra* note 27, Art. 5 (I)-(II). In order to comply with the provisions of the Mexican Constitution and further Congressional laws, Mexico reserved the strategic areas in NAFTA. *See* NAFTA, *supra* note 2, Annex 602.3.

- (ii) establishes that retail trade in gasoline and liquefied petroleum gas is exclusively reserved to Mexican individuals and Mexican corporations which have an exclusion of foreigners clause;³⁴
- (iii) establishes that foreign investment may participate up to 49 percent in the supply of fuel and lubricants for ships, airplanes, and railroad equipment;³⁵ and
- (iv) establishes that foreign investors can participate in the construction of pipelines for the transportation of petroleum and petroleum derivatives, as well as in the drilling of petroleum and gas wells in a percentage greater than 49 percent. However, in order to do so, the foreign investor must obtain the favorable resolution of the Foreign Investment Commission.³⁶

In the economic activities mentioned in sections (ii) and (iii) above, foreign investors cannot participate directly, through trusts, agreements, partnership or corporate agreements, pyramiding structures, or other mechanisms granting control or participation. Foreign investors can only participate through neutral investment.³⁷

2.4.2 Corporations

In the event that a foreign investor wants to participate, directly or indirectly, in an existing Mexican transportation, distribution or storage corporation in excess of 49 percent, it must obtain a favorable resolution from the following Commissions, if the transaction meets certain monetary thresholds:

- (i) A foreign investor must obtain the favorable resolution of the National Foreign Investment Commission if the total value of the assets of the Mexican corporation exceed the sum determined by this Commission on an annual basis. As of February 1997 the sum of the total value of the assets was \$394 million pesos,³⁸ and
- (ii) A foreign investor must obtain the favorable resolution of the Federal Competition Commission (“FCC”) in the event of three different scenarios established by the Federal Economic Competition Law (the “Antitrust Law”):³⁹ (a) If the value of a single transaction or a series of transactions exceeds 12 million times the General

³⁴ See FIL, *supra* note 27, Art. 6 (II).

³⁵ See FIL, *supra* note 27, Art. 7 (IV) (t).

³⁶ *Id.* Art. 8 (X)-(XI).

³⁷ The original concept of neutral investment was understood “as an investment made by a foreign investor in a Mexican corporation whose share participation will grant said investor only patrimonial rights (dividends, redemption of the investment and participation in the liquidation). Such companies can not have corporate-type rights, that is, voting rights or participation in the administrative body of the corporation.” See Alejandro López-Velarde, *supra* note 28, at 31. Since the promulgation of the FIL, the original concept of neutral investment was modified in order to establish the possibility that Secretary of Commerce and Industrial Development (“SECOFI”) may grant limited corporate rights to such investors. See FIL, *supra* note 27, Arts. 18-19.

³⁸ See FIL, *supra* note 27, Art. 9, 10 transitory.

³⁹ See Mex. Ley Federal de Competencia Económica (Federal Economic Competition Law) [hereinafter cited as the “Antitrust Law”], published in D.O. Dec. 24, 1992.

Minimum Wage for the Federal District (“GMW”); (b) if a single transaction, or a series of transactions, entail an accumulation of 35 percent of more of the assets or shares of an economic agent, whose assets or sales amount to, or exceed, 12 million times the GMW; or (c) two or more economic agents take part in the transaction, and their assets or annual volume of sales, jointly or separately, total more than 48 million times the GMW, and said transaction entails an additional accumulation of assets or capital stock in excess of 4 million, 800 thousand times the GMW.⁴⁰

III. THE NATURAL GAS INDUSTRY

3. The Natural Gas Regulation

The anxiously awaited Natural Gas Regulation (“Gas Regulation”) that provides the guidelines for participation in the distribution, transportation and storage of natural gas, was issued by the Executive branch on November 8, 1995.⁴¹ Pursuant to the Gas Regulation, foreign investors who wish to participate in this industry need to obtain a permit which will be granted by the CRE. Such permits are granted to Mexican or foreign entities for 30-year terms, renewable for additional 15-year periods.⁴²

3.1 Antitrust Issues

In order to protect the competition process in the distribution, transportation and storage of the natural gas market in Mexico by eliminating or regulating monopolies, monopolistic practices, concentrations and other acts that may affect the free flow of goods and services, the Gas Regulation provides that for each application, or bid proposal, private investors must notify the FCC. This notification will take place by providing the Commission with a copy of their application for a permit or their bid proposal.⁴³ It will also be necessary to notify the FCC in case of a transfer of an existing permit.⁴⁴

Despite the fact the Gas Regulation appears only to require notification, in practice, and according to the statement of purpose of the Antitrust Law, private investors must also obtain the favorable resolution of the FCC before proceeding with the contemplated investment.⁴⁵ The FCC

⁴⁰ *Id.* Arts. 16, 20.

⁴¹ *See* Gas Regulation, *supra* note 30. On March 8, 1996, the government published the official norm regarding the technical specifications for natural gas quality which must be observed by investors who participate in the transportation, distribution and storage of natural gas. *See* Mex. NOM-EM-001-SE-1996, *published* in D.O. March 8, 1996.

⁴² *See* Gas Regulations, *supra* note 30, Arts. 19, 53. Private investors must obtain all other permits, licenses and authorizations necessary to build, install and operate a distribution or transportation system.

⁴³ *Id.* Arts. 18, 32 (j), 41 (III) (c).

⁴⁴ *Id.* Art. 49.

⁴⁵ As a consequence of new international economic policies adopted by the Mexican government since its participation as a contracting party in the General Agreement on Tariffs and Trade (“GATT”) in 1986, as well as other international commitments such as NAFTA, Mexico enacted the current Antitrust Law. Since the entry into force of this law, the FCC has thoroughly reviewed transactions involving mergers and acquisitions, any act whereby companies, partnerships, shares, equity, trusts or assets in general are concentrated among competitors, suppliers,

will grant a favorable resolution after a review of the purpose of the investment and the effect that such investment will produce on the Mexican natural gas market. For such determination, the FCC will take into consideration the substantial power of the investor in the relevant market.⁴⁶

3.2 Distribution

Private investors can participate in the distribution of natural gas through:⁴⁷

- (i) Public bids: The first distribution permit for a geographical zone must be issued through public bid. The CRE, through the public tender procedure, will grant to the winner the exclusive right for 12 years for the construction of the distribution system and the receipt, transmission, and delivery of gas within the geographic zone;⁴⁸ and
- (ii) Applications: Permits can be granted after the period of exclusivity mentioned above has lapsed. However, such permits will not confer exclusivity.⁴⁹

Distribution permits are granted for specific geographic areas, which will be established by the CRE taking into consideration several elements, including economic feasibility.⁵⁰

3.2.1 Present and upcoming Bids

The Plan for National Development for the period from 1995-2000 and the Program for the Development and Restructuring of the Energy Sector⁵¹ establish that the energy sector must evolve efficiently with the participation of the private sector, in those activities in which the law enables it to participate. In accord with these two plans, the first international public call regarding distribution of natural gas in Mexico was published, on March 1, 1996, in the Official Gazette of the Federation. Such bid set forth the development of the geographic zone encompassing Mexicali, Baja California.⁵² This permit was granted to a group formed by Pacific

customers or any other business entity, or participation of legal entities in new economic activities such as telecommunications and natural gas through the application and public call procedures.

⁴⁶ See Antitrust Law, *supra* note 39, Arts. 12-13. As part of the FCC's faculties and authorities, the FCC may impose corporate sanctions, such as the suspension, correction or elimination of the transaction, or a partial or total dissolution of the activities that result in the rendering of services related to natural gas. *Id.* Arts. 19, 35.

⁴⁷ "Distribution services include (i) the delivery and marketing of gas by a distributor to a final user in a geographic zone; or (ii) the receipt of gas at one or more points along the distribution system, as well as the delivery of a similar amount at a different point of the same system." See Gas Regulation, *supra* note 30, Art. 61.

⁴⁸ *Id.* Art. 28. Distributors who are participating in natural gas activities as of the effective date of the Gas Regulation (November 9, 1995), may continue conducting the activities. However, they must request the bidding process, or submit an application to obtain a distribution permit without bidding, from the CRE within six months following the effective date of the Regulation. The distributors that wish to obtain a permit without bidding will obtain exclusive rights for the construction of the system and the provision of the service of receipt and delivery of natural gas within the geographic zone for a term of five years. *Id.* Art. 8 transitory.

⁴⁹ *Id.* Art. 29, 32.

⁵⁰ *Id.* Art. 26.

⁵¹ See Mex. Programa de Desarrollo y Reestructuración del Sector de la Energía 1995-2000 (Program for the Development and Restructuring of the Energy Sector 1995-2000), published in D.O. Feb. 19, 1996.

⁵² See Mex. D. O. Mar. 1, 1996.

Enterprises International, San Diego Gas & Electric and Grupo Mexicano Próxima (the “Group”), on August 12, 1996.

Pursuant to petitions on behalf of the government of the state of Chihuahua and the principal consumers of natural gas of this state, the CRE published another geographic zone for distribution of natural gas on May 21, 1996. Such zone encompasses Chihuahua, Cuauhtemoc-Anahuac, and Delicias (the “Chihuahua zone”).⁵³ The Chihuahua zone was also won by the Group.

Furthermore, the CRE also published on November 29, 1996, a public call for the natural gas distribution in the geographic zone composed by the cities of Hermosillo, Guaymas and Empalme located in the Mexican State of Sonora (the “Sonora zone”). Said zone was won by the U.S. company “KN Energy”.

In addition to the above mentioned geographic zones, the CRE published on December 16, 1997 of the most important geographic zones for natural gas distribution in Mexico, the municipalities of Lerma, Metepec, Ocoyoacac, San Mateo Atenco, Toluca, Xonacatlan and Zinacantepec, in the State of Mexico (“Toluca”).

On July 2, 1997, the CRE published the denial of the proposed geographical zone submitted to said Commission by Distribuidora de Gas Natural del Estado de México, S.A. (“Diganamex”). Thus, the Commission commenced the procedure to allow private participation in the distribution of natural gas by publishing a Resolution in the Official Gazette of the Federation designating two of the most awaited geographical zones known as the Federal District and the Cuautitlan Texcoco Valley zones. Pursuant to the Resolution, two geographical zones are designated:

- (i) The Mexico City Metropolitan Zone. This zone is composed of the political subdivisions of Alvaro Obregón, Azcapotzalco, Benito Juárez, Coyoacan, Cuajimalpa, Cuauhtémoc, Gustavo A. Madero, Iztacalco, Iztapalapa, Magdalena Contreras, Miguel Hidalgo, Milpa Alta, Tlahuac, Tlalpan, Venustiano Carranza, Xochimilco, and the Municipality of Tlalnepantla.
- (ii) The Cuautitlan-Textcoco Zone. This zone is composed of the municipalities of Acolman, Atenco, Atizapán de Zaragoza, Coacalco, Cuautitlán Izcalli, Chalco, Chicoloapan, Chimalhuacán, Ecatepec, Huixquilucan, Ixtapaluca, Jaltenco, La Paz, Melchor Ocampo, Naucalpan, Nextlalpan, Nezahualcoyotl, Nicolas Romero, Tecamac, Teoloyucan, Tepetzotlán, Texcoco, Tlalnepantla de Baz, Tultepec, Tultitlán, Valle de Chalco-Solidaridad, and Zumpango, excluding the Municipality of Tlalnepantla.

The CRE will grant two distribution permits; one for the Mexico City Metropolitan Zone and the other one for the Cuautitlán-Textcoco Zone.

⁵³ *See* D. O. May 21, 1996.

It is expected that, in 1997, besides the Mexicali, Chihuahua, Sonora, Toluca, Panuco River (located in the State of Tamaulipas),⁵⁴ Mexico City, and Cuautitlán-Texcoco geographic zones, the CRE will publish public calls for the cities and municipalities of (i) the Bajío region composed of the municipalities of Leon, Celaya, Salamanca and Irapuato; (ii) the Laguna region composed of the municipalities of Torreon, Gomez Palacio and Ciudad Lerdo; (iii) the Baja California region composed of the municipalities of Tijuana, Rosarito, Ensenada and Tecté; (iv) Pachuca (located in the State of Pachuca); (v) Querétaro and San Juan del Río (located in the State of Querétaro); (vi) Cuernavaca (located in the State of Morelos); (vii) Puebla (located in the State of Puebla); (located in the State of Puebla); and (viii) Reynosa (located in the State of Tamaulipas).

Due to the lack of pipeline distribution infrastructure in the north and middle part of the Mexican Republic, public calls are also expected for the cities of Guanajuato and Durango. At the same time, in the southeast of the Mexican Republic, public calls are expected for the States of (i) Veracruz; and (ii) Yucatán.

3.3 Transportation

In general, Mexican or foreign corporations with a presence in Mexico can obtain permits from the CRE through the application process.⁵⁵ However, in some cases, and upon the request of the federal or state governments, the CRE may call for a public bidding process.⁵⁶

Transportation permits will be issued for defined routes and capacities. Such permits will provide the permitted with a non-exclusive right to build,⁵⁷ install and operate natural gas transportation systems.⁵⁸

The CRE has located transportation projects in (i) Ciudad Pemex-Mérida; (ii) Rosarito; (iii) Mérida-Valladolid; (iv) San Agustín Valdivia-Samalayuca-Chihuahua-Chihuahua; (v) Palmillas-Toluca; and (vi) Hermosillo-Guaymas.

3.3.1 Approval of the Pemex-Gas and Basic Petrochemical (“Pemex-G & BP”) Gradual Open Access Program for 1996-1997.

On August 7, 1996, the CRE approved the Gradual Open Access.

Program for 1996-1997, presented by Pemex-G & BP.⁵⁹ This program is composed of four phases: (i) during the First Phase (commencing on September 1, 1996), access will be granted

⁵⁴ Altamira is currently undergoing substantial development by foreign and national investors who are in the process of creating one of the most important petrochemical infrastructures in the world today.

⁵⁵ *See* Gas Regulation, *supra* note 30, Art. 20 (I) (a). Among other requirements, the application must include: “(i) proposed route; (ii) capacity of the project; (iii) description of the types of services to be rendered and their markets; (iv) justification of potential demand; (v) gas supply resources; (vi) if applicable, transportation agreements with specific users; (vii) gas flow diagrams; and (viii) if applicable, the effects of the project on relevant transportation systems. *Id.* Art. 32 (II).

⁵⁶ *Id.* Art. 24.

⁵⁷ *See* the restrictions established in the FIL, *supra* note 27 Art. 8 (X)-(XII).

⁵⁸ *See* Gas Regulation, *supra* note 30, Art. 23. Transportation service includes “the receipt of gas by the transporter at a point of the transportation system and the delivery of a similar amount at a different point of the system.” *Id.* Art. 59.

without any restriction whatsoever to all users of the isolated systems in Naco-Hermosillo, Ciudad Juárez and Piedras Negras, (ii) during the Second Phase (commencing on January 1, 1997), access will be granted to users who carry out imports equal to or in excess of 142 thousand cubic meters/day, in the Chihuahua, Torreon, Monterrey and Reynosa Sectors, During this phase, despite the fact that there is production in the zone, users of the transport service may buy imported gas; however, they may not buy gas directly from Pemex-G & BP's plants; (iii) during the Third Phase (commencing on June 1, 1997), access will be granted to users who make in-plant purchases, if their consumption is equal to or in excess of 142 Thousand cubic meters/day, in the Cardenas, Minatitlán, Tlaxcala, Venta de Carpio, Salamanca, Guadalajara, Madero, Veracruz, Mendoza and Valley of Mexico sectors, This phase will grant open access to all pipelines that transport natural gas; and (iv) during the Fourth Phase (commencing on November 8, 1997), access will be granted to all users in the entire domestic system of Pemex-G &BP, covering both imports and in-plant purchases.⁶⁰

Users who are interested in obtaining transport service may request it in writing from Pemex and send a copy of the same to the CRE.

3.4 Storage

Storage permits will be granted through formal request to the CRE.⁶¹
Such permits are granted for specific locations and defined capacity.⁶²
The application must include the project location as well as the capacity of the project.⁶³

3.5 Vertical Integration

The Gas Regulation authorizes that a single entity can be eligible to hold transportation, distribution and storage permits concurrently.⁶⁴

Nevertheless, a transporter will not be able to obtain a distribution permit if it delivers gas in the geographical zone where it wishes to obtain the distribution permit.⁶⁵

⁵⁹ *See* Me. Resolución del Pleno de la Comisión Reguladora de Energía sobre la Solicitud de Aprobación del Programa Gradual de Acceso Abierto 1996-1997 presentado por Pemex-Gas y Petroquímica-Básica (Resolution of the Board Members of the Regulatory Energy Commission as to the Approval of the Gradual Open Access Program for 1996-1997 presented by Pemex-Gas and Basic Petrochemical), *published* in D.O. August 7, 1996.

⁶⁰ Before each phase is commenced, PEMEX-G & BP must request and obtain approval from the CRE as to the general services to be rendered regarding the transport system, as well as the corresponding rates, in accordance with the *Directiva sobre la Determinación de Precios y Tarifas*. *See* Mex. Directiva sobre la Determinación de Precios y Tarifas para las Actividades Reguladas en Materia de Gas Natural DIR-GAS-001-1996 (Directive on Determining Prices and Rates in the Natural Gas Activities DIR-GAS-1996), *published* in D.O. Mar. 20, 1996.

⁶¹ "Storage service includes the receipt of gas at a certain point of the facilities of the storage system and the delivery, in one or several actions, of a similar amount at the same or nearby point of the same system. *See* Gas Regulation, *supra* note 30. Art. 60.

⁶² *Id.* Art. 25.

⁶³ *Id.* Art. 32 (III).

⁶⁴ *Id.* Art. 16.

⁶⁵ *Id.* Arts. 16-17, 31.

3.6 International Trade

The Gas Regulation dictates that the import and export of gas may be freely carried out pursuant to the Foreign Trade Law.⁶⁶ As a consequence of the modifications and reforms to the Petroleum Law, it is expected that imports of natural gas will no longer require prior authorization from the Mexican government. However, the exportation of natural gas will probably require prior authorization.⁶⁷

Importers and exporters shall provide information to the CRE as to their Foreign trade activities in accord with the Directives that the Commission will publish.⁶⁸

At the date of this article, the importers and exporters of liquid and gaseous natural gas are not required to comply with prior customs permits, authorization or any other restriction imposed by any public agency.

Importers of petroleum and other hydrocarbon must register in the Importers Registry.⁶⁹

The operation of pipelines that transport imported or exported gas, LPG or other by-products in a gaseous form, requires prior approval of the Ministry of Finance and Public Credit.⁷⁰

3.6.1 Imports of Natural Gas

⁶⁶ *Id.* Art. 3; *See* also Mex. Ley de Comercio Exterior (Foreign Trade Law), published in D.O. July 27, 1993, Arts. 15-16.

⁶⁷ The requirements to have the prior permission of SECOFI for the importation and exportation of natural gas was derogated. *See* Mex. Acuerdo que Establece la Clasificación y Codificación de Mercancías cuya Importación y Exportación está Sujeta a Regulación por parte de la Secretaría de Comercio y Fomento Industrial (Agreement Establishing the Classification and Codification of Merchandise whose importation and Exportation is subject to Regulation by the Ministry of Commerce and Industrial Development), published in D.O. Dec. 27, 1995, First Section. At the same time, there is no required authorizations or prior permits established by the Ministry of Energy. *See* Mex. Acuerdo que Establece la Clasificación y Codificación de Mercancías cuya Importación y Exportación está sujeta a Regulación por parte de la Secretaría de Energía (Agreement Establishing the Classification and Codification of Merchandise whose Importation and Exportation is subject to Regulation by the Ministry of Energy), published in D.O. Dec. 27, 1995, Second Section.

⁶⁸ Gas Regulation, *supra* note 30, Art. 3.

⁶⁹ *See* Mex. Ley Aduanera (Customs Law), published in D.O. Dec. 15, 1995, Art. 59 (IV). When the value of the importation exceeds \$1000 Mexican pesos, it is necessary to use the services of a custom agent and to submit an importation declaration.

⁷⁰ *See* Mex. Reglamento de la Ley Aduanera (Custom Law Regulation), published in D.O. June 6, 1996, Art. 31 *See* also Reglamento Interior de la Secretaría de Hacienda y Crédito Público (Internal Regulation of the Ministry of Finance and Public Credit), published, in D.O. Sept. 11, 1996, Art. 60 (XXX). This authorization shall include the (i) kind of merchandise that is imported or exported as well as the means used in the transportation; (ii) place or places in which the merchandise will enter and exit Mexico and, as the case may be, the location of connections to other means of transportation; (iii) kind of meters or the system of measuring the merchandise that must be installed; (iv) term of the authorization; and (v) customs oversight that will be established. *See* Custom Law Regulation, *supra* note 69, Art. 31. Pursuant to the Harmonized System of Designation and Codification of Merchandise, item 27.11 is comprised of petroleum gas and other gaseous hydrocarbons. Among the merchandise that are included in this group are natural gas, propane, butane, ethylene, propylene, butylene and butadiene, in liquid as well as gaseous states.

In order to import natural gas, the following tax rules for importation will apply: (i) the importation of liquid natural gas is exempt from the payment of the General Import Tax;⁷¹ (ii) for imports of gaseous natural gas when the importation is from a country with which Mexico does not have a written commercial agreement, there is a tariff equal to 10% of its commercial value.⁷² For gaseous natural gas imported from the United States or Canada, the applicable Import Tax is 7.0% for 1997.⁷³

3.6.2 Exports of Natural Gas

Many Mexican exports must pay export taxes. However, liquid or gaseous natural gases are exempted from paying these taxes.⁷⁴

3.6.3 Technical standards Applicable to the Importation of Natural Gas

The importation of natural gas is not required to comply with any Official Mexican Norms (“NOM’s”) when entering the Mexican Republic.⁷⁵ Nevertheless, once the product is in the country, several NOM’s apply to the transportation, distribution and operation of natural gas.⁷⁶

⁷¹ *See* Mex. Ley del Impuesto General de Importación (General Importation Tax Law) [hereinafter cited as the “GITL”], published in Dec. 18, 1995, Tariff Classification item 2711.11.01 of the Tariff Schedule of the GITL.

⁷² *Id.* Tariff Classification Item 2711.01.01.

⁷³ *See* Decreto que Establece la Tasa Aplicable para 1997 del Impuesto General de Importación para las Mercancías Originarias de América del Norte, Colombia, Venezuela, Costa Rica, Bolivia y Chile [Decree which Establishes the Applicable Rate for 1997 of the General Importation Tax for Merchandises of North American Origin, Colombia, Venezuela, Costa Rica, Bolivia and Chile,] published in D.O. Dec. 31, 1996.

⁷⁴ *See* Mex. Ley del Impuesto General de Exportación (General Exportation Tax Law) [hereinafter cited as “GETL”], published in D.O. Dec. 22, 1995, Tariff Classification Item 2711.11, 2711.21, respectively.

⁷⁵ *See* Mex. Acuerdo que Identifica las Fracciones Arancelarias de las Tarifas de la Ley del Impuesto General de Importación y de la Ley del Impuesto General de Exportación en las Cuales se Clasifican las Mercancías Sujetas al Cumplimiento de las Normas Oficiales Mexicanas en el Punto de Entrada de la Mercancía al País (Agreement Identifying the Tariff Numbers of the Tariff Schedule of the General Import Tax Law and the General Export Tax Law in which the Merchandise is subject to the Observance of the Official Mexican Norms at the Point of Entering the Country), published in D.O. Dec. 28, 1995.

⁷⁶ The most important NOM’s are the following: (i) NOM-060-SCFI-1994 (*see* D.O. Nov. 22, 1995); (ii) NON-061-SCFI-1994; (*see* D.O. Nov. 29, 1995); (iii) NON-002-SCT2/1994 (*see* D.O. Oct. 30, 1995); (iv) NOM-004-SCT2/1994 (*see* D.O. Sept. 13, 1995); (v) NOM-005-SCT2/1994 (*see* D.O. July 24, 1995); (vi) NOM-006-SCT2/1994 (*see* D.O. Aug. 23, 1995); (vii) NOM-007-SCT2/1994 (*see* D.O. Aug. 18, 1995); (viii) NOM-009-SCT2/1994 (*see* D.O. Aug. 25, 1995); (ix) NOM-010-SCT2/1994 (*see* D.O. Sept. 25, 1995); (x) NOM-011-SCT2/1994 (*see* D.O. Sept. 25, 1995); (xi) NOM-018-SCT2/1994 (*see* D.O. Aug. 25, 1995); (xii) NOM-019-SCT2/1994 (*see* D.O. Sept. 25, 1995); (xiii) NOM-023-SCT2/1994 (*see* D.O. Sept. 25, 1995); (xiv) NOM-024-SCT2/1994 (*see* D.O. Oct. 16, 1995); (xv) NOM-025-SCT2/1994 (*see* D.O. Sept. 22, 1995); (xvi) NOM-030-SCT2/1994 (*see* D.O. Oct. 20, 1995); (xvii) NOM-043-SCT2/1994 (*see* D.O. Oct. 23, 1995); (xviii) NOM-022-SCFI2-1993 (*see* D.O. Oct. 14, 1993); (xix) NOM-027-SCFI-1993 (*see* D.O. Oct. 15, 1993); (xx)

3.7 First-Hand Sale of Natural Gas

As mentioned before, the first-hand sale of domestic natural gas remains under the Pemex monopoly. Prices for the first-hand sale natural gas are set by the CRE. However, once the market has developed and several competitors are in place, such competitors may request the FCC to establish prices in accord initially with the competitiveness of the market place. In establishing prices, the CRE has to take into account costs, opportunities and conditions of gas competitiveness in the international market.⁷⁷

IV. LIQUIFIED PETROLEUM GAS (“LPG”)

4. Regulations of the distribution of LPG

In November 1993, the Mexican government published a Regulation applicable to the distribution of LPG. Such Regulation repealed the Petroleum Law for the distribution of Liquefied Petroleum Gas and the Regulation of Gas Distribution. Even though LPG is exclusively produced by Pemex, distribution is possible through the corresponding Pemex subsidiary or through service contracts. The distribution and sale of this fuel is subject to a governmental authorization from the Ministry of Commerce and Industrial Development (“SECOFI”). The National Treatment Principles established in the NAFTA are not applicable to the distribution of LPG as a result of Mexico’s reservation in Chapter 11 “Investment. In this manner, LPG distribution is exclusively reserved to Mexican individuals or corporations with exclusion of foreigners clauses.⁷⁸ However, it is expected that the use of LPG commonly subsidized by the

NOM-018/3-SCFI/1993 (see D.O. Oct. 14, 1993); (xxi)
NOM-018/4-SCFI-1993 (see D.O. Oct. 14, 1993); (xxii)
NOM-025-SCFI-1993 (see D.O. Oct. 15, 1993); (xxiii)
NOM-014-SCFI-1993 (see D.O. Oct. 11, 1993); (xxiv)
NOM-018-SCFI-1993 (see D.O. Oct. 19, 1993); (xxv)
NOM-018-SCFI-1993 (see D.O. Oct. 20, 1993); (xxvi)
NOM-021-SCFI-1993 (see D.O. Oct. 14, 1993); (xxvii)
NOM-021/2-SCFI-1993 (see D.O. Oct. 14, 1993); (xxviii)
NOM-021/3-SCFI-1993 (see D.O. Oct. 14, 1993); (xxix)
NOM-018/4-SCFI-1993 (see D.O. Oct. 19, 1993); (xxx)
NOM-023-SCFI-1993 (see D.O. Jan. 21, 1994); (xxxii)
NOM-031-SCFI-1993 (see D.O. July 11, 1994); (xxxii)
NOM-034-SCFI-1994 (see D.O. July 13, 1994); (xxxiii) NOM-092-SCFI-1994;
(xxiv) Draft of NOM-079-SCFI-1994 (see D.O. Dec. 9, 1994); (xxxv)
NOM-094-SCFI-1994 (see D.O. Dec. 13, 1995); (xxxvi) NOM-095-SCFI-1994
(see D. O. Dec. 29, 1994); (xxxvii) NOM-096-SCFI-1994 (see D.O. Dec. 6., 1994);
(xxxviii) Draft of NOM-097-SCFI-1994 (see D.O. Dec. 28, 1994); (xxxix)
NOM-098-SCFI-1994 (see D.O. Jan. 10, 1995); (xl) NOM-099-SCFI-1994 (see
D. O. Jan. 18, 1995); (xli) NOM-CCAT-014-ECOL/1993 (see D.O. Oct. 22, 1993);
(xlii) NOM-CCAT-004-ECOL/1993 (see D.O. Octg. 22; 1993); (xliii)
NOM-CCAT-010-ECOL/1993 (see D.O. Oct. 22, 1993); (xliv)
NOM-076-ECOL-1995 (see D.O. Dec. 26, 1995); (xlv) NOM-EM-001-SE-1996 (see D.O. Mar. 8, 1996); and (xlvi)
NOM-027-SCFI-1994 (see D.O. Jan. 12, 1995).

⁷⁷ See Gas Regulation, *supra* note 30, Arts. 8, 12. The Gas Regulation defines a first-hand sale as “the first of gas of national origin by Petróleos Mexicanos to another party for delivery in the national territory.” *Id.* Art. 2 (XXI).

⁷⁸ See, FIL, *supra* note 27, Art. 6.

government will be replaced in the future by the use of natural gas once the natural gas market is developed to do so.

4.1 Imports and Exports of Gases

A 10% tariff will be imposed on imports from those countries which have not executed trade agreements with Mexico for the importation of liquid propane gas;⁷⁹ liquid ethylene, propylene, butylene and butadiene;⁸⁰ and any kind of gas in a gaseous state.⁸¹ The tariff scheme applied to imports from countries with which Mexico does have a written trade agreement is similar to that applied to the importation of natural gas described above. However, liquid butane gas,⁸² and the mixture of butane and liquid propane gases, are exempt from payment of tariffs. Additionally, all of the petroleum gases and the remaining hydrocarbon gases are exempt from payment of export tariff.⁸³

4.2 Non-Tariff Restrictions to the Importation of Gases

In order to import liquid gases (propane, butane, ethylene, propylene, butylene and butadiene, the mixture of butane gas and propane, and the rest of the liquid gases), and the gases in a gaseous, state, it is necessary to obtain a prior importation permit from SECOFI.⁸⁴

V. THE BASIC AND SECONDARY PETROCHEMICAL INDUSTRY.

Needless to say, the petrochemical industry represents one of the most important industries in Mexican economy, since it is a large supplier of products to other industries. However, over the last few years, a great controversy has arisen in Mexico related to the possibility of participation by national or foreign private investors in the basic petrochemical industry (“BPI”) and in the secondary petrochemical industry (“SPI”). This controversy was intensified on July 26, 1995, when the General Director of Pemex announced the disincorporation of various assets for the production of various assets for the production of secondary petrochemicals located in 61 secondary petrochemical plants. The petrochemical plants. The petrochemical plants are organized in 10 petrochemical complexes (Cangrejera, Morelos, Pajaritos, Cosoleacaque, Tula, Salamanca, Poza Rica, San Martín Texmelucan, Camargo and Escolín).⁸⁵

5.1 Strategic Areas

⁷⁹ See GITL *supra* note 71, Tariff Classification Item 2711.12.01.

⁸⁰ *Id.* Tariff Classification Number 2711.14.01.

⁸¹ *Id.* Tariff Classification Item 2711.29.99.

⁸² *Id.* Tariff Classification Item 2711.13.01.

⁸³ See GETL *supra* note 74, Tariff Classification Item 27.11.12-01 Art. 1. See also Mex. Código Fiscal de la Federación (Federal Tax Code), *published* in D.O. Dec. 14, 1995, Art. 8.

⁸⁴ See Mex. Acuerdo que Establece la Clasificación y Codificación de Mercancías cuya Importación y Exportación está Sujeta a Regulación por parte de la Secretaría de Comercio y Fomento Industrial (Agreement Establishing the Classification and Codification of Merchandise whose Importation and Exportation is Subject to the Regulation by the Ministry of Commerce and Industrial Development), *published* in D.O. Dec. 27, 1995, Tariff Classification Numbers 2711.12.01, 2711.13.01, 2711.19.01, 2711.19.99, 2711.29.99, respectively, First Section.

⁸⁵ 86 per cent of the secondary petrochemical activities is located in Coatzacoalcos, State of Veracruz, Mexico.

As previously established, for the purpose of reserving in favor of the Mexican State the development of the BPI, the Constitution dictates that the State has the exclusive (i) dominion and ownership, (ii) manufacturing, and (iii) exploitation over such industry. Nevertheless, this Constitutional provision does not consider the SPI as a strategic area.⁸⁶ In this way, in the development of BPI national and foreign private investments is proscribed. The development of the BPI is carried out PEMEX-G & BP exclusively.

On the other hand, since SPI is not being part of the strategic areas established in the Constitution, the public, private and social sectors may participate in such industry. The public sector participates in the SPI through Pemex-Petroquímica.⁸⁷

5.2 Regulation of the Petroleum Provisions of the Regulatory Law to Article 27 of the Mexican Constitution in the Petrochemical Sector.

In addition of being considered a strategic area by the Constitution, BPI is considered part of the oil and gas industry according to the Petroleum Law.⁸⁸ With the inclusion of the BPI in such industry, the intervention of the Mexican State in the BPI was confirmed. However, the Mexican Congress did not include the SPI within the scope of the oil and gas activities due to the fact that the SPI is not part of the strategic areas mentioned by the Constitution. In 1959, through the Regulation of the Petroleum Law, the state monopoly was reaffirmed as to BPI in its chapter VIII.⁸⁹ However, chapter VIII was repealed by the Regulation of the Regulatory Law to Article 27 of the Mexican Constitution in the Petrochemical Sector (“Petrochemical Regulation”) in 1971.⁹⁰ The Petrochemical Regulation defines the petrochemical industry including: (i) activities reserved to the State; (ii) activities in which the private sector can participate; (iii) procedures in order to obtain permits and authorizations; and (iv) the establishment of faculties and attributions of the *Comisión Petroquímica Mexicana* (Mexican Petrochemical Commission).

⁸⁶ See Const. *supra* note 4, Art. 28.

⁸⁷ The public sector develops strategic areas exclusively, maintaining the ownership, control and organization of the public entities in the federal government at all times. *Id.* Arts. 25, 28. Based on the legal nature of Pemex-G & BP and Pemex-Petrochemical they do not have capital stock certificates and can not have foreign participation in a direct manner. Based on the Mexican Constitutional principle of “*Autoridad Formal de la Ley*” (Formal Authority of the Law), in case that the federal government decides to extinguish Pemex-G & BP and Pemex-Petrochemical, it will be necessary to amend the Pemex Charter or promulgate another congressional law. *Id.* Art. 72 (1).

⁸⁸ See Petroleum Law, *supra* note 3, Art. 3.

⁸⁹ In this Regulation the BPI was established under the following terms and conditions: (i) the Petrochemical industry is understood as the performance of chemical and physical processes for the manufacturing of products from the transformation of petroleum, gas and by-products; (ii) Pemex is in charge of carrying out the monopoly on inputs used as basic industrial raw materials, as well as those raw materials of social economic interest, proscribing the participation of private individuals in the elaboration of said products; (iii) the participation of private individuals in the manufacturing of products resulting from subsequent petrochemical processes; (iv) it is a faculty of the federal executive to solve disputes regarding the participation of the public or private sector in the petrochemical industry; and (v) the Mexican Petrochemical Commission is granted with revisory faculties as an auxiliary technical consulting organization in petrochemical matters of the *Secretaría de Energía, Minas e Industrias Paraestatales* (Ministry of Energy, Mines and Paraestatal Industries, now Ministry of Energy). See Regulation of the Petroleum Law, *supra* note 7, Arts. 3, 26-29.

⁹⁰ See Mex. Reglamento de la Ley Reglamentaria del Artículo 27 Constitucional en el Ramo del Petróleo, en Materia de Petroquímica, (Regulation of the Petroleum Provisions of the Regulatory Law of Article 27 of the Mexican Constitution in the Petrochemical Branch) [hereinafter cited as “Petrochemical Regulation”], published in D.O. Feb. 9, 1971.

5.3 Resolutions by which the Basic and Secondary Petrochemical Products are classified.

Neither the Petroleum Law and its Regulation, NOR the Petrochemical Regulation, provide us with the classification of basic and secondary petrochemicals. In order to distinguish between basic and secondary products, it is necessary to review the resolutions issued by the federal executive through the Energy Ministry. In recent years, the reclassification carried out by the Mexican government has allowed private individuals to participate in the production of primary products which were not available to such investors before. At the time Mexico changed its international economic policy by entering the General Agreement on Tariffs and Trade, better known as "GATT", in 1986, the deregulation of the BPI began. Therefore, in October, 1986, the government reclassified petrochemical products by reducing 50 basic products to only 34 products.⁹¹ Three years later, only 20 products were considered basic, establishing 66 secondary products.⁹² Subsequently in 1991, terbutylic methyl either was also reclassified to be considered as a secondary product.⁹³ Finally, in accordance with the latest resolution, the BPI encompasses only 8 products: (i) ethane; (ii) propane; (iii) butane; (iv) pentane; (v) hexane; (vi) heptane; (vii) naphthas; and (viii) the raw material for lampblack.⁹⁴

The validity of the classifications made by the government of the BPI and SPI has been questioned from a legal standpoint. According to our legal system, the scop and development of strategic areas such as the BPI shall be exclusively established by the Congress. The executive branch can not develop such areas in regulations, decrees or classification documents since it does not have the Constitutional power to do so. In accordance with the Constitution, the President of Mexican Republic is only empowered to provide for the exact observance of the law in the administrative sphere.⁹⁵

This Mexican practice of classifying basic and secondary products through regulations and resolutions has gone beyond the stipulations of the Constitution. In effect the executive office has virtually become a legislator by invading the faculties attributed to the Congress of the Union. As a result, investors should be aware that the new reforms to the petrochemical industry may be in conflict with basic constitutional principles.

⁹¹ *See* Mex. Resolución que Clasifica los Productos Petroquímicos que se Indican, dentro de la Petroquímica Básica o Secundaria (Resolutions by Which the Petrochemical Products are Classified within the Basic or Secondary Petrochemical), *published* in D.O. Oct. 13, 1986.

⁹² *See* Mex. Resolución que Clasifica los Productos Petroquímicos que se Indican, dentro de la Petroquímica Básica o Secundaria (Resolutions by Which the Petrochemical Products are Classified within the Basic or Secondary Petrochemical), *published* in D.O. Aug. 15, 1989.

⁹³ *See* Mex. Resolución que Clasifica los Productos Petroquímicos que se Indican, dentro de la Petroquímica Básica o Secundaria (Resolutions by Which the Petrochemical Products are Classified within the Basic or Secondary Petrochemical), *published* in D.O. June 7, 1991.

⁹⁴ *See* Mex. Resolución que Clasifica los Productos Petroquímicos que se Indican, dentro de la Petroquímica Básica o Secundaria (Resolutions by Which the Petrochemical Products are Classified within the Basic or Secondary Petrochemical), *published* in D.O. Aug. 17, 1992.

⁹⁵ *See* Const. *supra* note 4, Art. 89 (I).

5.4 Foreign Investment Prohibitions

During the administration of President Echeverría, foreign participation was allowed up to 40% in the SPI. However, the new FIL did away the 60 percent-national investment-40 per cent foreign investment requirement. Therefore, today, foreign investors may participate up to a 100 per cent in the SPI.⁹⁶

The liberalization of the SPI is possible cause of both the commitments which Mexican negotiators made with Canada and the United States in NAFTA, and, as indicated above, the fact that SPI is not part of the strategic areas mentioned in the Constitution.

5.5 Disincorporation of the Assets of Pemex-Petroquímica

Based on the consideration that SPI is not an strategic area and is not a part of the oil and gas industry, Pemex –recognizing its lack of financial resources to develop SPI- solicited the participation of the private sector. Pemex’s income has not been enough to recapitalize and provide its petrochemical complexes with high technology.

On November 14th, 1995, the Mexican government announced its intention to disincorporate the assets of Pemex-Petrochemical, when it published public call No. PPQ-01 in the Official Gazette of the Federation.⁹⁷ Pursuant to this call, interested national and foreign investors can participate in the bidding process to purchase assets for the production of secondary petrochemicals located in the petrochemical complex called “Cosoloacaque” in the State of Veracruz. Nevertheless, the Mexican government announced the definite cancellation of the sale of the assets of Cosoloacaque.

5.6 Modifications to the Legal Framework Applicable to the Basic and Secondary Petrochemical Industry.

Motivated by the problems that the Mexican Government confronted in connection with the disincorporation of the assets of Pemex-Petroquímica from the end of 1995 until the middle of 1996, the same which have been discussed in this article, such as the first public call on October 16, 1996, through which the government offered the disincorporation of the assets located in the Cosoloacaque Petrochemical Complex, the President of the Republic submitted before the House of Representatives an initiative reforming and argumenting the Law of Petroleum, for the purpose of legally defining with greater precision what products are included in the BPI and ending the unauthorized practice of classifying petrochemical products through administrative resolutions, generating legal uncertainty among investors. Accordingly, section II of Article 3 of the Petroleum Law was amended to expressly define primary products as, (i) ethanol; (ii) propane; (iii) butane; (iv) pentane; (v) hexane; (vi) heptene; (vii) raw material for lampback; (viii) naftas; and (ix) methane. Methane is considered part of BPI when it originates

⁹⁶ See 1973 FIL, *supra* note 27. Art. 5.

⁹⁷ See Mex. Petróleos Mexicanos, Pemex-Petroquímica, Secretaría de Energía, Convocatoria Pública No. PPQ-01 (Petróleos Mexicanos, Pemex-Petrochemicals, Ministry of Energy, Public Call No. PPQ-01), *published* in D.O. Nov. 14, 1995. The intention of the federal government with the sale of the assets used in the SPI, is that the income obtained during the last year in this industry, as well as the fresh capital that the government will receive with such sale, should be devoted to the upstream activities, such as exploration and exploitation, in order to develop even more our industry and to strengthen Pemex so that it can compete in the international market.

from hydrocarbon deposits located within the national territory, and when it is utilized as a primary material in industrial territory, and when it is utilized as a primary material in industrial petrochemical processes. It should be mentioned that the establishment of methane as a primary product shall in no way affect the May 11, 1995, Mexican Government liberalization regarding distribution, transportation, and storage in the natural gas industry. As a matter of fact, for the purpose of clearly establishing the treatment of methane pertaining to its transportation, distribution and storage as natural gas, the following paragraph was added to Article 4 of the Petroleum Law.

“The transport, storage and distribution of methane gas remains included within the activities and the regimen referred to in the previous paragraph”

On the other hand, in processes that occur later on in the productive chain, there are occasions when certain oil-bearing subproducts are obtained, such as primary petrochemical products. Article 4 of the Petroleum Law was also amended to include the following paragraph for the purpose of expressly establishing the State’s exclusivity regarding the handling, use and exploitation of the same:

“When in the production of petrochemical products, products distinct from the basic products in section II of Article 3 of this Law are obtained as subproducts, oil-bearing or basic petrochemicals, the same shall be utilized in the productive process within the same unified or contiguous plants or else sold to Petroleos Mexicanos (Pemex) or its subsidiaries, under the terms of the administrative dispositions that the Ministry of Energy issues”.

The foregoing signifies that such subproducts shall not be permitted to enter into commerce or be commercialized by private enterprise given that, as we have established, it is Pemex and its subsidiaries who are able to carry out the industrialization of the primary products in conformity with the provisions of our Constitution and the same Petroleum Law. At the same time, for the purpose of creating the possibility that private enterprise may participate in BPI, the obligation is established to give notice to the Ministry of Energy in the following terms:

“The Companies that fall within the case referred to in the previous paragraph shall have the obligation to give notice to the Ministry of Energy, who shall have the right to verify compliance with the cited administrative provisions and, where necessary, impose the sanctions that are referred to in Article 15 of the Law”

Finally, the modifications to the Petroleum Law include, as a sanction for private parties that commit the above-cited violation, a fine of 1,000 to 100,000 times the minimum general wage then in force in the Federal District and the forfeiture to Pemex of the basic oil-bearing subproducts or petrochemicals generated.

VI. INTERNATIONAL PETROLEUM AGREEMENTS

Despite the fact that the modifications and reforms to the Petroleum Law constitute the first step in the liberalization of the state monopoly, the Mexican Congress did not permit international energy agreements, such as: (i) Product Sharing Agreements; (ii) Participation Agreements; and (iii) Concessions. Pursuant to the Constitution and the Petroleum Law and its

Regulation, corporations are prohibited from entering into agreements with Pemex in which they may have ownership right in the production of hydrocarbons.

Based on the prohibition to execute the abovementioned energy agreements, foreign investors may still participate in the upstream and downstream industries through service and public work contracts. In this way, Pemex, under the terms of the Law on Public Acquisitions and Works, may request drilling service agreements, and turn-key contracts, among others.⁹⁸ Nevertheless, these agreements can not be considered concessions, license, production-sharing agreements, or participation agreements since all the oil and gas products must belong to Pemex.⁹⁹

On December 22, 1993, the Pemex Charter was amended in order to allow Pemex and its subsidiaries to submit their controversies to foreign tribunals or arbitration as dispute settlement mechanisms, and choice of foreign law provisions in their contracts. These modifications allow the parties to incorporate arbitration clauses instead of using Mexican courts as the forum for resolving their disputes with Pemex.¹⁰⁰

VII. CONCLUSION

Mexico currently is liberalizing the economic activities previously proscribed to foreign investors, such as the oil and gas industry, in order to create new jobs in foreign capital.

On the other hand, Mexico would like to strengthen Pemex in terms of its upstream activities, namely exploration and exploitation. In order to accomplish this task, the Mexican government has opted to allow foreign and domestic private investment in downstream activities which are not considered strategic areas by the Constitution. This is accomplished in two ways. First, the previous all-encompassing role of Pemex has been reduced by allowing foreign participation in the transportation, distribution and storage of natural gas. Pemex is also attempting to reduce its role in SPI, and has announced the sale of its petrochemical assets. Second, the participation of the private sector in the natural gas industry and SPI will allow Pemex to use its revenues for the exploration and exploitation of wells, thereby permitting Mexico to comply with the domestic demand and eventually become an important exporter of such products.

Even though the Mexican Congress did not include the possibility of executing international energy contracts, such as participation, concession and production-sharing agreements, the reforms to the oil and gas industry represents the first step in allowing private participation in the most important activity in Mexico.

⁹⁸ The Mexican Legal Ordinances applicable to government procurement and public services contracts are the (i) Constitution (*see* Const. *supra* note 4, Art. 134); (ii) NAFTA (*see* NAFTA, *supra* note 2, Chapter X “Government Procurement”); (iii) Law on Public Acquisitions and Works (*see* Mex. Ley de Adquisiciones y Obras Públicas (Law on Public Acquisitions and Works), *published* in D.O. Dec. 30, 1993, Arts. 1, 3, 4-6); (iv) Petroleum Law and its Regulation (*see* Petroleum Law *supra* note 3, Art. 6); (v) Pemex Charter, *supra* note 11, Art. 4).

⁹⁹ Pemex and its subsidiaries can not transfer, sell, attach, garnish, seize, encumber or compromise the oil and gas, while it remains unexploded and has not been extracted from the oil field. *See* Regulation of the Petroleum Law, *supra* note 7, Art. 19.

¹⁰⁰ *See* Pemex Charter, *supra* note 11, Art. 14.

As can be readily observed, the oil and gas industry in Mexico is regulated by several legal ordinances. It is therefore crucial to understand the application of these laws on a case-by-case basis.