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HIGHLIGHTS

Unitization of Oil and Gas Megafields

Recent discoveries of deepwater oil and gas megafields in Latin America have caused many governments to develop unitization legislation to provide rules if the reservoir extends beyond a licensed area or in several jurisdictions. Bolivia, Brazil, Colombia, Ecuador, Nicaragua, and Trinidad and Tobago are some of the countries that have developed legal frameworks for unitization. *Page 3*

New Rules for Foreign Participation in the Mexican Oil and Gas Industry

Late last year, several reforms were enacted which represent an important step forward in the participation of both foreign and domestic private capital in the energy sector. A detailed analysis of the new rules is provided. *Page 24*

What Did the Fifth Summit of the Americas Have to Say About U.S. Relations with Latin America?

The Fifth Summit of the Americas held in the Trinidadian capital in mid-April had little to show as far as substantive progress and represents a lost opportunity for the US to exhibit leadership. There was great speculation that the 34 leaders attending would agree to launch an Energy Partnership for the Americas, which did not happen. *Page 8*

Conflict in Brazil Patent and Trademark Office Concerning Agreements Between Private Parties on Trademark Use

For years the Brazilian Patent and Trademark Office was hostile to agreements between private parties designed to allow trademarks to coexist. Guidelines published in 1997 changed this position, but reportedly dissenting opinions within the Office and an internal proposal would resume the prior position. *Page 17*

Mexico's Lower House Approves Constitutional Amendment To Allow Certain Supreme Court Tax Decisions To Have Precedent

Mexico's Lower House approves a constitutional amendment allowing Supreme Court decisions in certain tax cases to have general applications instead of applying only to the party filing the law suit. *Page 18*

CONTENTS

Brazil

Exercising Prior User Rights. By José Antonio B. L. Faria Correa (Dannemann Siemsen).....p. 16

The BPTO and Trademark Coexistence Agreements. By José Antonio B. L. Faria Correa (Dannemann Siemsen).....p. 17

Mexico

Mexico's Lower House Approves Constitutional Amendment Providing for the General Application of Decisions of the Supreme Court in Certain Tax Cases. By Mario Melgar (Cacheaux, Cavazos & Newton, L.L.P.).....p. 18

Mergers in Mexico – A Practical Approach. By Mauricio Foeth (Curtis, Mallet-Prevost, Colt & Mosle LLP).....p. 20

Modifications and Reforms to the Oil and Gas Industry in Mexico: The New Rules for Foreign Participation. By Alejandro López-Velarde (Lopez Velarde, Wilson, Abogados, S.C.)...p. 24

Regional

Unitization of Oil and Gas Megafields in Latin America – includes coverage of **Bolivia, Brazil, Colombia, Ecuador, Nicaragua, and Trinidad and Tobago**. By Giovanni Loss and Felipe Alice (Fulbright and Jaworski, L.L.P.).....p. 3

Macro Outlook: Latin America. By Guillermo Mondino and Rodrigo Valdes (Barclays Capital).....p. 6

Latin American Law & Business Report 2008 Cumulative Indices

Subject Index, p. 33
Country Index, p. 37

Contents Continued on Page 2

Modifications and Reforms to the Oil and Gas Industry in Mexico: The New Rules for Foreign Participation

By Alejandro López-Velarde (Lopez Velarde, Wilson, Abogados, S.C.)

Introduction and Background

On November 28, 2008, several legal ordinances applicable to the oil and gas industry were enacted. The approval of these modifications and reforms represents a historic break with the past and step forward in the participation of private capital either national or foreign in the energy sector. This sector is without a doubt the most important one in Mexico.

Domestic controls and regulation of foreign interests were nearly non-existent during the administration of President Porfirio Diaz (1880-1911). Succeeding administrations set out to limit foreign participation in the oil and gas sector. In order to carry out this objective, the Mexican government 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. Nevertheless, 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 Article 27 to foreign-owned oil companies. Concern on the part of 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.

The full significance of Article 27 was not felt until 1938 when President Lazaro Cardenas expropriated private property interests throughout Mexico, including the oil and gas industry. This sector became a symbol of Mexican sovereignty. However, it was not during Cardenas administration that the national monopoly was placed

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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 named *Ley Reglamentaria del Artículo 27 Constitucional en el Ramo del Petróleo* (Petroleum Provisions of the Regulatory Law of Article 27 of the Mexican Constitution—the “Petroleum Law”). This monopolistic stronghold was strengthened with the enactment of the Regulation of the Petroleum Law in 1959, during the next administration of President Adolfo Lopez Mateos.

The approval of these modifications and reforms to the oil and gas industry represents a historic break with the past and step forward in the participation of private capital either national or foreign in the energy sector.

The possibility of private participation in the oil and gas industry was contemplated until 1994 during the final year of the Carlos Salinas administration. The major impetus behind this proposal was the desire to increase production of domestic natural gas, providing enough of this resource for domestic consumption and reducing Mexico’s reliance on natural gas imported from the United States. A plan for private participation gained momentum because Mexico had been unable to develop the natural gas industry on its own, because of a poor pipeline and distribution infrastructure, environmental concerns and lack of financial resources, particularly in the northern regions of the country.

In 1995, the administration of President Ernesto Zedillo privatized the natural gas sector and disincorporated *Petróleos Mexicanos* (“Pemex”) secondary petrochemical assets.

Three important considerations have to be recalled in the Mexican oil and gas industry:

- i. The beginning of the oil and gas industry was in 1904 due to the exploration and production of the first wellhead in the State of San Luis Potosi carried out by a foreigner, Mr. Edgard Doheny; and

- ii. During expropriation times with the administration of Lazaro Cardenas international energy agreements such as risk contracts and participation agreements were allowed.
- iii. 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 Constitutional provisions established in Articles 27 and 28 were broadly interpreted by the Congress through the Petroleum Law and its Regulation. This broad interpretation of the Constitution was recently reviewed by the Executive and Legislative branches in order to allow private participation in sectors of the oil and gas industry where the Constitution does not establish restrictions and provide the right tools to Pemex to comply with the national demand and compete in the international arena.

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 public and private legal ordinances. The most important legal ordinances applicable to this sector are the (i) Mexican Constitution; (ii) Petroleum Law; (iii) Pemex Law; (iv) Foreign Investment Law ("FIL"); (v) National Hydrocarbon Commission Law; (vi) Organic Law of the Federal Public Administration ("LOAPF"); (vii) Federal Law on Paraestatal Entities; (viii) Public Acquisitions, Leases and Service Law ("Acquisitions and Service Law"); (ix) Public Works and Related Services Law ("Public Works Law"); (x) Sustainable Exploitation of Energy Law; (xi) Exploitation of Renewable Energies and Financing of the Energy Transition Law; (xii) Energy Regulatory Commission Law; (xiii) Regulation of the Petroleum Law; (xiv) Natural Gas Regulation; (xv) Regulation of Liquefied Petroleum Gas (the "LPG Regulation"); (xvi) international treaties such as the North American Free Trade Agreement ("NAFTA"); (xvii) Mercantile Code; (xviii) Federal Civil Code; among others.

Pemex and Related Public Agencies

One of the most important modifications made by the Congress is related with the administration, budget, financing, and powers of Pemex. With the new Pemex Law the Mexican government has published the following legal ordinances applicable to Pemex:

- i. **Decree that Creates the Petróleos Mexicanos Institution.**- Pemex was created by the Mexican Congress via decree, immediately after the expropriation of the oil and gas industry during the administration of President Lazaro Cardenas. Subsequently, Pemex took control of and administered the assets expropriated from the foreign owners. In general terms, this Decree gave powers to Pemex's Board of Administration to

appoint the General Manager and to the Ministry of Treasury and Public Credit (Secretaría de Hacienda y Crédito Público-the "Ministry of Treasury") the possibility to use the income obtain by 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 public and private legal ordinances.

- ii. **Organic Act of Pemex ("Pemex Charter-1971").**- 33 years later, a new Pemex Charter was published in the Official Gazette of the Federation ("D.O."). The Pemex Charter-1971 also restricted the free determination of Pemex since the Executive branch had the authority to appoint until the position of Sub-Directors and the Ministry of Treasury kept the authority of approving Pemex's budget and the authorization for the company's funding.
- iii. **Organic Act of Petróleos Mexicanos and Subsidiary Entities (the "Pemex Subsidiary Charter").**- The Mexican government in 1992 submitted a bill to the Mexican Congress which restructured Pemex in order to guarantee its role in the Mexican economy and the international market. Upon approval of the bill, the Pemex Subsidiary Charter changed the structure of the operative subdirections of Pemex into subsidiaries thereby creating: (a) Pemex-Exploration and Production ("Pemex-E&P"); (b) Pemex-Refining; (c) Pemex-Gas and Basic Petrochemicals ("Pemex-G&BP), and (d) Pemex-Petrochemicals. Pemex and its subsidiaries have been decentralized public entities of the federal Mexican government, entrusted by the Nation to carry out the oil and gas industry.

The above-mentioned subsidiary organization has been criticized for (a) duplication of functions and activities, (b) expensive operation; (c) transfer price problems among the subsidiaries; (d) lack of coordination; and (e) lack of a unique organization pursuing the same goal.

- iv. **The new Pemex Law.**- The new Pemex Law incorporates inter alia the following modifications:

Denomination

It shows the first change in its name from Organic Act of Petróleos Mexicanos and Subsidiary Entities to Pemex Law.

Oil and Gas Industry, Continued on page 26

Oil and Gas Industry (from page 25)

No Mention of Subsidiaries

It changes the structure of Pemex without mentioning its subsidiaries with the purpose to incorporate as many subsidiaries as needed for the development of the oil and gas industry providing more flexibility to Pemex. The new subsidiaries will be proposed by the Board of Administration to the President. The Pemex's subsidiaries incorporated before the promulgation of the Pemex Law will continue operating until a new reorganization decree is issued by Pemex.

Legal Status

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 Pemex Law and the Petroleum Law. Foreign participation in Pemex or in its subsidiaries is clearly prohibited.

Pemex's new subsidiaries will also enjoy independent legal status with capacity to own property, and will be independently responsible for the functions entrusted to them.

Activities

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.

Autonomous Decisions

With the possibility to use its spare income and to make adjustments to its own budget without the approval of the Ministry of Treasury as long as Pemex reaches its own financial statements' goals, Pemex is provided with additional resources and liberalized of the heavy and lengthy authorizations from the Executive branch.

Boar of Administration

Previous to the publication of the Pemex Law, the Board of Administration was integrated by 11 members--6 from the government and 5 from Pemex's Union. The Presidential Bill established the possibility to incorporate 4 new private professional members to be appointed by the President with the approval of the Senate Chamber or the Permanent Commission of the Congress. Today, the Board of Administration includes 6 members from the government; 5 from Pemex's Union; and 4 private professional individuals. The members of the Board will last in their position for 6 years with the possibility to be re-appointed again for the same period.

The impossibility to reduce the participation of the Union in the Board of Administration has been deeply criticized. One thing is true: no place in this world considers having and reserving 5 places out of 11 or today 15 in the most important company of a country.

At the same time, the Pemex Law grants to the Board of Administration new duties and powers including programming, budgeting, financing, coordinating, investing, and evaluating Pemex and its subsidiaries. Further, it will be in charge of obtaining the public works, acquisitions, leases and services to be provided to Pemex and issue the corresponding bidding guidelines.

Pemex's new subsidiaries will also enjoy independent legal status with capacity to own property, and will be independently responsible for the functions entrusted to them.

Transparency

Pemex in all of its activities will have to provide an annual report of the status of the industry to the Congress which will be also published in the internet. Further, the following entities and individuals will review Pemex's performance: (a) Auditing and Performance Evaluation Committee (Auditoría y Evaluación de Desempeño); (b) Examiner to be appointed by the Executive branch; (c) Internal Control Department (Órgano Interno de Control); (d) Superior Federal Auditing (Auditoria Superior de la Federación); and (e) External Auditor.

Finally, the Pemex Law calls for the incorporation of Committees which will act as auxiliary departments of the following Board of Administration: (a) Investment and Strategy (Estrategia e Inversiones); (b) Compensations (Remuneraciones); (c) Acquisitions, Leases, Works and Services (Adquisiciones, Arrendamientos, Obras y Servicios); (d) Environment and Sustainable Development (Medio Ambiente y Desarrollo Sustentable); (e) Transparency and Accountability (Transparencia y Rendición de Cuentas); and (f) Development and Technological Innovation (Desarrollo e Inovación Tecnológica). Pemex's Union will not be part of these Committees.

Participation of Foreign Capital in Each Sector of the Oil and Gas Industry
The Exploration and Exploitation Activities and the Mexican Constitution

The Congressional reforms did not contemplate any change in the Mexican Constitution even when the Mexican paramount law has been modified 473 times--16 of

them related with its Article 27. Consequently, the Nation maintains direct dominion over the subsoil as well as the exclusive right of exploitation and development of petroleum and gas. Thus, private ownership of hydrocarbons is strictly prohibited, reserving ownership of petroleum and all solid, liquid, and gaseous hydrocarbons to the State. This is a Constitutional right that is inalienable and imprescriptible without the possibility to concede oil exploration and exploitation rights to private parties.

Strategic Areas

The so-called strategic areas were not modified by the current reforms. Consequently, all domestic petroleum and hydrocarbon resources and basic petrochemicals are deemed to be strategic activities which are exclusively reserved to the State. Private participation, either national or foreign, is clearly prohibited.

In addition to the provisions specified above, the law applicable to the regulation of foreign capital, the FIL ratifies that petroleum and other hydrocarbons, as well as the basic petrochemical industries are reserved to the Mexican State. Nevertheless, neither Article 27 nor Article 28 provides a clear cut definition and scope concerning the oil and gas industry. Pursuant to the new modifications and reforms made to the Petroleum Law, the petroleum industry in the hands of the State 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 without including associated gas to the mineral coal wellheads since the Mineral Law will regulate its exploitation; and
- iii. The 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.

Based on the constitutional and FIL restrictions above-mentioned, private parties have worked with Pemex in the upstream activities under the terms and conditions of the Acquisitions and Service Law and the Public Works Law (jointly referred as the "Procurement Laws").

Policies Behind the Modifications in the Upstream Sector

In general terms, the Presidential bill called for the possibility to grant the so-called Incentive Contracts ("Contratos Incentivados") with the purpose to (a) increase the oil and gas reserves. The Mexican giant wellhead called Cantarell which is the sixth largest wellhead in the world is declining rapidly; (b) explore and produce in deep waters attracting the right technology, acknowledged and management; and in general (c) modernize Pemex.

Incentive Contracts

Congress authorized two regimens applicable to the administrative contracts to be executed by Pemex with the private sector:

- i. **For substantive activities.**- Related to exploration and production activities whereby the Procurement Laws will not be applicable. Instead, applicable regulation will be the (a) Pemex Law and its Regulation; and (b) general guidelines to be issued by the Pemex's Board of Administration which must include as a general rule the public bidding process in accordance with Article 134 of the Constitution. Article 134 dictates that acquisitions, leases, services and public works, shall be awarded by public bidding after a public bid tender so that reliable proposals can be freely submitted in sealed envelopes, that shall be opened publicly, for purposes of insuring the State of the best available conditions with respect to price, quality, financing, opportunity and any other pertinent circumstances. Therefore, the general rule must be that there is a as opposed to a public bidding process and the exception the restricted invitation or the direct award.

It is important to mention that as part of a policy towards obtaining better prices for Mexican public entities, the Pemex Law establishes the possibility to hold Reverse Auctions (*ofertas subsecuentes de descuento*).

It is important to mention that as part of a policy towards obtaining better prices for Mexican public entities, the Pemex Law establishes the possibility to hold Reverse Auctions (*ofertas subsecuentes de descuento*).

In the substantive activities, the Acquisitions, Leases, Works and Services Committee will be in charge of (a) reviewing, evaluating and recommending the annual acquisitions, leases, services and public works programs; (b) evaluating the possibility to avoid the general public tender procedure advising the possibility of having a restricted invitation procedure or a direct award; (c) the administrative interpretation of the applicable legal ordinances in the acquisitions, leases, services, public works, and sale of goods applicable to Pemex; (d) evaluating the contract models to be executed with the private sector; (e) authorizing the incorporation of sub-committees; (f) providing opinions requested by the Board of Administration regarding the execution of contracts and the possible applicable suspension, rescission or early termination, among others.

Oil and Gas Industry, Continued on page 28

Oil and Gas Industry (from page 27)

- ii. *For non-substantive activities.*- Activities such as the purchase of materials and equipment for Pemex's offices, construction of administrative buildings and so on will be subject to the Procurement Laws. The Federal Controller Bureau (Secretaría de la Función Pública) will continue to be in charge of the administrative application of the Procurement Laws.

Terms and Conditions of Administrative Contracts

The new general terms and conditions applicable to administrative contracts to be executed with Pemex are the followings:

- a. Pemex and its subsidiary entities will be able to execute any kind of acts, agreements and contracts and issue negotiable instruments keeping at all times the ownership and control of the hydrocarbons in the hands of the Mexican State.
- b. Public work and service contracts are valid and shall be executed within the four corners of Article 6 of the Petroleum Law. That is to say (a) payment shall be in cash; (b) Ownership of hydrocarbons cannot be granted to contractors; (c) Production Sharing Agreements, Participation Agreements or any Agreement which share percentage in the production or the value of the sale of hydrocarbons or its by-products are not allowed.
- c. No rights will be granted on the oil and gas reserves. Consequently, contractors cannot record the oil and gas reserves in their financial statements as their own assets.
- d. The control and direction of the oil and gas industry will be vested in the Nation.
- e. The price to be paid to contractors shall be established in the Contract in accordance with the rules established in the Civil Code. Each contract must establish a set price.
- f. Compensation shall always be in cash. Therefore, percentage upon the production or the sale of the production is clearly prohibited. These payments shall be similar to the ones paid in the oil and gas industry in Mexico and internationally.
- g. Pemex will be able to pay incentives according with the production and performance to be carried out by contractors. Nevertheless, it is important to mention that these payments cannot become the contract in production sharing agreements, participation agreements, or strategic alliances in upstream activities.
- h. Preferential rights for the acquisition of the oil and gas are not allowed.
- i. Sharing production agreements, joint venture agreements in the strategic activities established in Articles 27 and 28 of the Constitution and Article 3 of the Petroleum Law are not allowed.
- j. One of the most important changes in the admin-

istrative contract regime is the possibility to make modifications in the contracts in issues related to the incorporation of new technical applications, variation of prices in inputs, raw materials, equipment to be used in the works or for the acquisition of new data obtained during the execution of the works which will benefit the project. Further, additional compensation will be granted when (i) Pemex obtains benefits for the execution of the works in advance by the contractor; (b) Pemex obtains or it is the beneficiary of the application of new technologies; or (c) additional circumstances brought by the contractor increase the income of Pemex and better results are produced as long as percentage upon the value of the sales or upon the production of hydrocarbons are not engaged by the parties. This possible compensation shall be expressly established at the time of execution of the corresponding contract.

The Mexican Congress did not permit international energy agreements, such as: (i) Product Sharing Agreements; (ii) Participation Agreements; (iii) Earn-in Contracts; and (iii) Concessions. Private investors including foreign concerns may participate in the upstream sector through the execution of Incentive Contracts.

- k. Compensation shall (a) be in cash; (b) be reasonable in terms of the standards and usages of the industry; (c) be authorized in the Pemex's budget; (d) be a fixed price or predetermined formula in accordance with the civil law. Further, multi annual contracts might establish revisions for the incorporation of advance technologies or variation in prices of the materials and equipment to be used in the project.
- l. Liquidated damages might be applicable for breach of contract or environmental damages.
- m. National content will be requested in the execution of contracts.

Any provision established in contracts which do not comply with the above-mentioned mandate will be considered void ad initio.

International Energy Agreements

Despite the fact that the modifications and reforms to the Petroleum Law constitute an important step to liberalize this sector, the Mexican Congress did not per-

mit international energy agreements, such as: (i) Product Sharing Agreements; (ii) Participation Agreements; (iii) Earn-in Contracts; and (iii) Concessions. Thus, corporations are prohibited from entering into agreements with Pemex in which they may have ownership right in the production of hydrocarbons. Consequently, private investors including foreign concerns may participate in the upstream sector through the execution of Incentive Contracts and the terms and conditions of the Pemex Law and the general guidelines to be issued by the Pemex's Board of Administration.

Drilling of Petroleum and Gas

The FIL establishes that foreign investors can participate 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 a favorable resolution of the Foreign Investment Commission.

Legal Considerations

In addition to the above-mentioned considerations it is important to mention that Incentive Contracts do not violate Articles 27 and 28 of the Constitution since the ownership of the hydrocarbons remain in the hands of the Mexican State. Nevertheless, the way to grant Incentive Contracts through new contractual rules issued by the Executive branch through the Pemex Board of Administration could be a direct violation to Article 134 of the Constitution since this constitutional article dictates that it has to be established in Congressional laws with the purpose to secure to the Mexican State principles such as the best price, transparency, impartiality, clarity, efficiency, honesty and in general equal conditions without the possibility to guide the bidding process in favor to an specific potential supplier. Consequently, the legality of the Pemex Board of Administration rules will be made when same are published and used for a contracting process whereby any term, condition, faculty or authority that goes beyond or lacks the principles of Article 134 of the Constitution could be subjected to constitutional challenge.

The Refining Industry

The refining industry is not expressly contemplated in the regulation of Articles 27 and 28 of the Constitution since it is not a natural resource and the wording of Article 28 does not include the refining industry. Nevertheless, Pemex's monopolistic practice in this sector has been established in Article 3 of the Petroleum Law which expressly dictates the following:

"The petroleum industry encompasses:

I. ...refining, transportation, storage, distribution and first-hand sale of petroleum, and its by-products obtained through the refining process"

Further, Article 24 of the Regulation to the Petroleum Law establishes that:

- i. The Nation shall carry out the refining industry through Pemex.
- ii. In turn, Pemex shall be able to refine national, foreign or a combination of national and foreign hydrocarbons for national consumption or for exportation purposes.
- iii. When hydrocarbons belong to a third foreign party, the refining process may be carried out by Pemex but just for exportation purposes of the products.

Based on the above text, and the wording of Article 24 of the Regulation to the Petroleum Law, the following interpretations are relevant:

- a. Pemex is in charge of the production of refining products when it is used by national or foreign hydrocarbons.
- b. The Article only makes reference to Pemex's possible participation in the refining process when foreign hydrocarbons are used for exportation purposes. Or, stated in different terms, Pemex is not obligated to do the process when foreign hydrocarbons are used as raw materials.
- c. In the modern history of the oil and gas industry private investment has not been allowed in the refining sector. It was back in 1941 when the Petroleum Law established the possibility to grant concessions to the private sector for this sector.

The Presidential Bill

President Calderon's bill in this sector was not approved. The bill called for the participation of the private sector since domestic demand has increased rapidly. The modernization of the current refineries located in the Municipalities of Salamanca, Tula, Madero, Minatitlan; Salina Cruz and Cadereyta is not enough. Mexico needs to incorporate at least 4 additional refineries. This private participation proposed by the President was through a maquila scenario whereby (i) Pemex was not allowed to transfer the ownership of hydrocarbons to private investors; and (ii) private investors were requested to deliver the corresponding end products to Pemex. Further, it was established that the first hand sale of refining products shall be regulated by the CRE.

Part of the doctrine in Mexico considers that the foreign investment participation is allowed in the refining sector if national resources are not used (maquila scenario). The truth is that the above-mentioned legal ordinances and the case law ("jurisprudencia") do not shed any additional light as to the application of the Constitution, the FIL; the Petroleum Law; and the Regulation to the Petroleum Law.

Retail Trade in Gasoline and Other Refining Products

The Congressional modifications did not open up the possibility to the foreign investors to participate in the retail trade in gasoline. In fact, the Petroleum Law reiter-

Oil and Gas Industry, Continued on page 30

Oil and Gas Industry (from page 29)

ates the prohibitions established in the FIL in which only Mexican individuals and Mexican corporations which have an exclusion of foreigner's clause can participate in this sector. Furthermore, foreign investment may participate up to 49 percent in the supply of fuel and lubricants for ships, airplanes, and railroad equipment.

The Petrochemical Industry

Petrochemicals represent one of the pillars of the Mexican industrial structure, as an economic supplier of widely diffused raw material. In 1959, during the administration of President Adolfo Lopez Mateos, the development of the petrochemical industry was established as priority. During this period, the possibility of agreeing to the use of private capital to develop the industry in question, started to become apparent to the Mexican Government. In fact, the then Director of Pemex, Mr. Pascual Gutierrez Roldan, analyzed the possibility of "associating with interested Mexican and foreign private parties for the production of polyethylene". Later, during the sixties and beginning of the seventies, the petrochemical industry developed greatly. Production in the volume of petrochemicals increased 53 times with 359 petrochemical permits were awarded between the years of 1961 and 1983, 163 of which were delivered to companies, and investment rose to more than 500 thousand million of Pesos.

The Petrochemical Industry boom was spurred on by the "Six Year Basic Petrochemical Program 1977-1982" during the era of the administration of President Jose Lopez Portillo. Under this program, the whole petrochemical industry was established as a priority, reflecting the government's intention to develop this industry to levels of international competition. Also, in 1986, a new program was enacted for further developing economic petrochemical activities, known as the "Integral Program for Development of the Petrochemical Industry", attempting among other things to convert the domestic petrochemical industry into a net generator of foreign currency. Nevertheless, during the nineties a large controversy has arisen in Mexico about the constitutionality of the basic petrochemical industry ("BPI") and the secondary petrochemical industry ("SPI"). This controversy was intensified since the month of July of 1995, when the Mexican Government began to realize the possibility of selling off various assets for the production of secondary petrochemicals, located at 61 petrochemical plants, distributed in 10 complexes owned by Pemex-Petrochemical. Various sectors of the Mexican community opposed the sale and the possibility to liberalize the petrochemical industry to the private sector, among them, senators and representatives, unions, industrial leaders, associations, industrial chambers, Mexican doctrine and of course certain political parties, which have made this controversy their own under the supposed protection of the Mexican sovereignty.

The foregoing caused a climate of uncertainty and lack of confidence with the domestic and foreign investors who wished to invest in this sector in Mexico.

The FIL establishes that foreign investors can participate in the drilling of petroleum and gas wells in a percentage greater than 49 percent. However, the foreign investor must obtain a favorable resolution of the Foreign Investment Commission.

In 1992, through the promulgation of the Pemex Subsidiary Charter, Pemex-G&PB and Pemex-Petrochemical were created as decentralized bodies with their own legal status and patrimony. These public entities have been in charge of carrying out the activities of transportation, distribution, storage and commercialization of petrochemical products.

The Basic and Secondary Petrochemical Industry

One of the fundamental characteristics of the petrochemical industry is its integration into long productive chains which then supply other fields of economic activity, the first link of which are the primary and the secondary petrochemical products. In order that said chains function in an efficient manner, adequate articulation is required between the supply of raw materials and the establishment of prices culminating in various products that we use in our daily life. Before going on to a legal analysis of the industry in question, it is appropriate to briefly set forth the headings which each one of these two industries encompasses.

- i. **Basic Petrochemicals.**- The Mexican Doctrine has said that the BPI includes:

"Such products which are susceptible to serving as basic industrial raw materials which result from the petrochemical processes founded on the first important chemical transformation which is done to products or sub-products by refining natural petroleum hydrocarbons."

Thus, the BPI is a source of supply of raw materials for the SPI. Furthermore, the Mexican Constitution considers the BPI industry as a strategic area in which only the Mexican State can participate in its development and commercialization. The national BPI is integrated by (a) ethane; (b) propane; (c) butane; (d) pentane; (e) hexane; (f) heptane; (g) naphtha; (h) the raw material for smoke

lampblack; and (i) methane when such product comes from hydrocarbons located in Mexico and it is used as a basic industrial material in petrochemical industrial processes. Furthermore, Pemex maintains control over the production, transportation, distribution, storage and first-hand sale of Mexican basic petrochemical products. In practice, private companies acquire the national products of the first processes from Pemex-G&PB or from abroad and with them create hundreds of chemicals which are transformed into articles for daily use.

ii. **Secondary Petrochemicals.**- The SPI has been defined by the Mexican Doctrine as:

"The subsequent transformations of basic products with which is obtained a large diversity of intermediate and use petrochemical products"

As indicated above, since the administration of president Adolfo López Mateos in 1959, private parties have been able to, and have obtained the authorization to participate in the SPI. This right was curtailed in 1973, with the passage by the Mexican Congress of the Law to Promote Mexican Investment and to Regulate Foreign Investment. Through this legislation, the Mexican Congress limited foreign participation in the SPI to a percentage not to exceed 40%. This protectionist law was repealed and replaced in 1993 by the FIL, which allowed foreign investors to freely participate in the SPI, without being subject to any percentage limitation. The centerpiece of the FIL was the repeal of the general standard of 49% foreign investment (51% Mexican investment) applicable to all economic activities not otherwise subject to a specific percentage limitation in the FIL. Stated in other words, foreign and domestic private investors can participate in the SPI in terms of (a) production; (b) transportation; (c) distribution; (d) storage; and (e) commercialization.

In the event that the production process of secondary petrochemical products results in basic petrochemical products, the investors will be able to use such primary products in their own facilities or sell them to Pemex and its subsidiaries except when the commercial value of the products is less than 25% of the total sales made by the private producer in a year. In any event, private investors are obligated to notify the Ministry of Energy as to the generation of such basic petrochemical products.

The Presidential Bill

Interesting enough, the Presidential bill did not consider any modifications in this sector. The Congress approved issues related with the fertilizer industry which of course is not enough to comply with the national demand in this sector. Mexico is probably the only country in the world that divides the petrochemical industry in BPI (where only the Mexican State participates) and SPI (where public and private sectors participate). Nevertheless, this industry is characterized for its integration into

long productive chains which then supply other fields of economic activity with technical production difficulties to be divided since the production of secondary products sometimes leads to the production of primary products. Without any question this division and prohibition of participation in the BPI by the private sector has led this sector to production and commercial deficits in the international commercial balance. No technical or commercial justification exists to divide the petrochemical industry in basic and secondary.

Foreign and domestic private investors can participate in the Secondary Petrochemical Industry in terms of (a) production; (b) transportation; (c) distribution; (d) storage; and (e) commercialization.

The Natural Gas Industry

Neither the Presidential bill nor the Congress modified the participation of the private sector in the natural gas industry. The Natural Gas Regulation provides the guidelines for participation in the distribution, transportation and storage of natural gas. Thus, 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. Today, the participation of the private sector (national or foreign) is carried out under the following conditions and restrictions:

- i. Pemex's present transportation pipelines are not for sale;
- ii. 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 (a) operation of pipelines; (b) transportation; (c) distribution; and, (d) storage;
- iii. By analyzing the Petroleum Law, in conjunction with the FIL, it is possible to deduce that foreign companies can engage in the above-mentioned activities. Specifically, investing companies may 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; and
- iv. 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.

Oil and Gas Industry, Continued on page 32

Oil and Gas Industry (from page 31)

Liquefied Petroleum Gas ("LPG")

Mexico is a leading country in consumption of LPG for householding purposes. In December 5, 2007, the Mexican government published the new Regulation applicable to the distribution of LPG. Such Regulation repealed its predecessor Regulation of 1999. In this sector the public and private participation is as follows:

- i. Pemex keeps in an exclusive manner the production of LPG.
- ii. Distribution of Pemex's LPG is possible through Pemex-G&BP or through service contracts.
- iii. LPG distribution is exclusively reserved to Mexican individuals or corporations with exclusion of foreigner's clauses; while the transportation and storage is opened up to the national or foreign private sector.

Finally, it is important to mention that the current modifications to the oil and gas industry did not include any change in this sector.

The Associated Gas Industry

The Petroleum Law now establishes that the associated gas to the mineral coal deposits shall be subject to the provisions applicable to the transportation, distribution and storage of gas.

Transportation, Distribution and Storage of Gases and By-products

Due to lack of financial resources that can be dedicated to increase and modernize the transportation, distribution and storage infrastructure, the Executive bill called for the modification to the Petroleum Law allowing the participation in these sectors of the private sector. It is worth mentioning that these sectors are not expressly contemplated in the regulation of Articles 27 and 28 of the Constitution. However, the broad interpretation made of the Constitution established in the hands of the State these sectors in the Petroleum Law which dictates that these sectors shall be managed and developed by Pemex. In fact, Article 3 of the Petroleum Law expressly dictates that the oil and gas industry encompasses the transportation, distribution and storage of gas, refining and petrochemical products and by-products. Transportation of these products by truck or ship is already allowed to the private sector, but the Congress did not pass the Presidential proposal even though the pipeline infrastructure is more than 40 years old and working at its full capacity. The private community does not know why legislators continue keeping these sectors in the hands of the State.

Construction of Pipelines

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 Invest-

ment Commission, which may authorize foreign investment in excess of the prescribed percentage.

Public Bonds

In order to to finance Pemex and share the wealth of the oil and gas industry with the Mexican people, Congress approved the issuance of Public Bonds. This financing mechanism found its background in the Petrobonos which were previously issued in 1977 to take advantage of the oil high prices. Nevertheless, when the oil and gas prices collapsed and Mexican reserves declined Petrobonos were not longer in circulation in 1990. These public bonds do not grant any exploitation, corporate, or assets rights upon Pemex and its subsidiaries. The holders of the bonds shall be Mexican individuals and Mexican corporations. An Examiner will be appointed whose obligation will be to report to the Executive branch the information filed by the Members of the Board and represent the interests of the bond holders.

Conclusion

The constitutional restrictions established in Articles 27 and 28 were broadly interpreted by the Mexican Congress through the enactment of the Petroleum Law and its Regulations back in 1958-1959. Further, Pemex has become the first national tax payer supporting the national debt and keeping a minimum amount for investment purposes in the upstream and downstream activities. Before the current November 28, 2008 modifications and reforms to the oil and gas industry, this sector was modified two times in 49 years: (a) on May 11, 1995 with the purpose to allow the participation of the private sector in the transportation, distribution and storage of natural gas; and (b) on November 13, 1996, in the petrochemical industry.

Based on the above-mentioned considerations, the current administration of President Calderon tried to provide the right tools to Pemex with the purpose to comply with the national demand and compete in the international arena bringing the participation of the private sector and fresh capital in those activities which do not have constitutional prohibitions (e.g., refining, transportation, distribution and storage of refining and petrochemical products and gases). However, the Mexican Congress did not allow such participation. The Congress did establish new rules in the granting of administrative contracts by Pemex to the private sector in the upstream activities through Incentive Contracts which have to be tested and confirmed by the parties involved (Pemex and private sector) as to their convenience in the modern times of the oil and gas industry.

On the legal side, the Mexican government had a golden opportunity to avoid any constitutional challenge if the modifications were made in the Constitution. Why not make the reform right in the Mexican paramount law, which has been modified 473 times--16 of them related with its Article 27. However, the government chose not to modify and update the Constitution to the new demands and challenges in the oil and gas industry is equal to loose our sovereignty. □