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Legal Update
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Analysis of Proposed Hydrocarbon Legal Regime in Mexico

President Enrique Peña Nieto has introduced to the Mexican Congress nine new bills, as well as proposed amendments to several existing laws, to implement the constitutional energy reform that became effective on December 21, 2013. The constitutional energy reform eliminates a restrictive legal framework that has limited private investment and participation in Mexico's energy industry for more than 75 years.

The nine bills introduced on April 30, 2014, are:

- The Hydrocarbons Law;
- The Hydrocarbon Revenues Law;
- The Electric Industry Law;
- The Geothermal Energy Law;
- The Law of the Coordinated Regulating Agencies of the Energy Sector;
- The Law that Creates the National Agency of Industrial Security and Environmental Protection of the Hydrocarbon Sector;
- The Petróleos Mexicanos (PEMEX) Law;
- The Federal Electricity Commission (CFE) Law; and
- The Law of the Mexican Oil Fund for Stabilization and Development.

It is expected that the Mexican Congress will consider the implementing legislation in a special session during the second half of June 2014. This legal update addresses the main features of the proposed Hydrocarbons Law and the Hydrocarbon Revenues Law.

I. Overview

Together, the proposed Hydrocarbons Law and the Hydrocarbon Revenues Law establish a new legal framework for all hydrocarbon-related activities in Mexico,[1] including the following:

- Surface and geophysical surveying;
- Exploration for, and extraction of, hydrocarbons;
- The treatment, refining, transportation, storage, marketing and sale of petroleum and petroleum products;
- The processing, compression, liquefaction, decompression and regasification, as well as the transportation, storage, distribution and retail sales of natural gas;
- The transportation, storage, distribution and retail sales of liquefied petroleum gas; and
- Pipeline transportation and storage of petrochemicals.

The Hydrocarbons Law restates two of the main principles governing the Mexican energy sector as established by the Constitution (as amended on December 21, 2013):

- That the hydrocarbons in place within Mexico's territorial boundaries belong exclusively to the state and, thus, no concessions[2] may be granted, and
- That the exploration and production (E&P) of hydrocarbons are state strategic activities.[3]

For E&P activities, the proposed Hydrocarbons Law provides two different regimes to be regulated by the National Hydrocarbon Commission (CNH): entitlements (called "*asignaciones*" in Spanish) granted to State Productive Enterprises (wholly owned state entities, including PEMEX) and E&P contracts entered into with State Productive Enterprises or private parties. For midstream and downstream activities, the proposed law establishes a "permit" regime to be generally regulated by the Ministry of Energy (SENER) and the Energy Regulatory Commission, as further described in Section III below.

Within 180 calendar days of the enactment of the Hydrocarbons Law, the executive branch is to issue regulations (*reglamento*) relating to the law.

II. Upstream Sector

A. PEMEX ROUND ZERO

The transitional articles of the constitutional reform establish the so-called "Round Zero" process, during which PEMEX has the right to request E&P rights over areas it currently has under production, or that it is actively exploring. Any E&P rights granted to PEMEX under the Round Zero process would be under the entitlement regime (defined in Section II(B) below). One of the main objectives of the reform is that, after this initial round, PEMEX is to compete on an equal footing with other operators in obtaining additional contract areas.

On March 21, 2014, PEMEX submitted its Round Zero request to the SENER, requesting to retain the following:

- 100 percent of Mexico's producing areas;
- 83 percent of Mexico's proven and probable reserves (2P Reserves); and
- 31 percent of Mexico's prospective resources.

SENER has a 180-day review period (ending on September 17, 2014) from the date of the PEMEX request to decide which areas will be granted to PEMEX under the entitlement regime. SENER's decision will be made with the technical support of the CNH, taking into account PEMEX's technical, financial and operational capabilities.

B. ENTITLEMENTS

An entitlement is the administrative act by which the executive branch grants PEMEX, or another State Productive Enterprise, the right to explore and produce hydrocarbons in a determined area and for a particular duration, usually under an onerous tax regime established by law.

SENER, with the favorable opinion of the CNH, will be the entity responsible for granting or modifying entitlements to PEMEX, or any other State Productive Enterprise, for the performance of E&P activities.

Although the Hydrocarbons Law does not refer specifically to the Round Zero process, it proposes the legal framework pursuant to which SENER will grant entitlements to PEMEX or other State Productive Enterprises.

Article 6 of the proposed Hydrocarbons Law provides that entitlements shall be granted on an "exceptional" basis, which would seem to permit the granting of area entitlements to PEMEX even after the Round Zero process.

The Hydrocarbons Law provides that PEMEX (and other State Productive Enterprises, as applicable) may only assign or transfer an entitlement to another State Productive Enterprise with prior consent from SENER. To meet its obligations under the entitlements, PEMEX may only enter into service contracts with private parties in regard to entitlements, which may only provide for cash payments to the contractor.

It is through the entitlement regime that PEMEX has historically received areas for E&P activities in Mexico. However, the entitlements to be granted to PEMEX pursuant to the

proposed legal framework would generally have stricter terms than the entitlements currently held by PEMEX, including work programs and mandatory relinquishment and termination events.

The Hydrocarbon Revenues Law establishes the fiscal regime for PEMEX's entitlements, which generally maintains the same onerous fiscal terms that are currently established by the Federal Law on Fees (*Ley Federal de Derechos*).

C. MIGRATION TO CONTRACTS

The Hydrocarbons Law provides that PEMEX may request the approval of SENER for the migration or conversion of entitlements into E&P contracts. In the migration process, the Ministry of Finance shall establish the fiscal terms relating to those migrated contracts.

SENER is to decide the type of E&P contract that an entitlement may be migrated to.

With respect to entitlements migrated into contracts, PEMEX (and other State Productive Enterprises) may enter into "alliances or associations" with private parties. The proposed Hydrocarbons Law also establishes that, where PEMEX decides to enter into associations with private parties with respect to a migrated E&P contract, a tender process will be conducted by the CNH to select PEMEX's partner. The technical and economic terms relating to the tender process will be established by SENER and the Ministry of Finance, respectively. Article 13 of the proposed Hydrocarbons Law provides that this tender process shall be conducted in a way that is most beneficial for the Nation (and, notably, not PEMEX).

The proposed Hydrocarbons Law further provides that SENER will seek PEMEX's favorable opinion with regard to the experience and the technical, financial and operational capabilities that bidders would need to meet in order to participate in the bidding process.

Under the proposed Hydrocarbons Law, PEMEX would not have the ability to select its own partner, or to conduct its own bidding process to select its partner, with respect to entitlements migrated into contracts. At this point, it is unclear what economic factor would be evaluated in bidding rounds conducted by the CNH to select a joint venture partner for PEMEX with respect to entitlements migrated into contracts.

D. E&P CONTRACTS

E&P contracts shall only be granted through a competitive bidding process, organized and regulated by different State entities and regulators.

Under the constitutional reform and the proposed Hydrocarbons Law:

- SENER is charged with selecting areas for public bidding and establishing the technical and financial requirements for bidders;
- The CNH is charged with conducting the bidding process, evaluating bids and awarding contracts; and
- The Ministry of Finance is charged with establishing the economic and fiscal terms of the E&P contracts.

The new contract models for E&P activities are: (i) licenses, (ii) production-sharing contracts, (iii) profit-sharing contracts and (iv) service contracts, among others that may be established by law. The constitutional reform establishes that the law shall provide that "maximizing the nation's revenues" is to be the guiding principle in implementing this framework. The Hydrocarbon Revenues Law provides for the economic aspects relating to each of the contract models.

i. License Contracts

Pursuant to the Hydrocarbon Revenues Law, the license contracts shall provide for the following payments in favor of the Nation:

- A signing bonus;
- Exploratory phase fees;

- Royalties; and
- A payment that consists of a percentage of operating profits or the contract value of hydrocarbons.

After making these payments, the contractor may take the hydrocarbons in-kind at the wellhead. All of the above payments shall be paid in cash by the contractor. These payments are in addition to any taxes owed by the contractor pursuant to the Mexican Income Tax Law or other tax laws.

a. Signing Bonus

The signing bonus amount shall be established by the Ministry of Finance in the bid terms for each tender process relating to E&P contracts. The signing bonus is to be paid to the newly established Mexico Oil Fund.

Pursuant to the statement of intent of the proposed Hydrocarbon Revenues Law, the signing bonus will be paid at the moment and under the terms established in the specific tender process. The signing bonus will be known before the bid submission and will not be considered a factor in awarding the contract. The signing bonus is not expected to represent a "significant" percentage of the resources to be received by the Nation. It is mainly a "mechanism to guarantee the seriousness of the economic bids." The amount of the signing bonus would not be recoverable for purposes of determining operating profit.

b. Exploratory Phase Fees

License contracts shall establish a monthly payment during the exploratory phase with respect to non-producing areas. The concept is similar to the delay rentals usually established under oil and gas leases in the United States. The exploratory phase monthly fees are as follows: (i) $2,650 Mexican pesos (having a current value in US dollars of approximately $205) per square kilometer during the first 60 months of the contract term and (ii) $4,250 Mexican pesos (having a current value in US dollars of approximately $330) per square kilometer starting from month 61 of the contract term. These amounts shall be adjusted annually for inflation (using the Mexican National Consumer Price Index). The purpose of these payments is to incentivize the contractor to move promptly to a production phase. The amount of the exploratory phase fees would not be recoverable for purposes of determining operating profit.

The exploratory phase fees are to be paid to the newly established Mexico Oil Fund.

c. Royalties

License contracts shall establish royalties in favor of the Nation that shall vary depending on the type and market price of the particular hydrocarbon (crude oil, associated and non-associated natural gas or condensates) actually produced. Royalties are payable in cash.

Royalty rates shall be applied to the "contract value" of produced hydrocarbons, which is calculated by multiplying the measured volume of production by its "contract price." The contract price for each type of hydrocarbon refers to its market price in US dollars, as adjusted pursuant to a mechanism to be established in each E&P contract. The mechanism will take into account the hydrocarbon's quality, API gravity, marketing, and transportation and logistical costs, among other factors.

Crude oil royalties start at 5 percent when the contract price of crude oil is below US$60 per barrel and would increase as the contract price of crude oil increases.[4] For example, when the contract price of crude oil is US$100, a 10 percent royalty would be applicable. The same royalty structure would apply to condensates.[5]

The proposed Hydrocarbon Revenues Law offers an economic incentive for the development of non-associated natural gas when its market price is low (below US$5.00). This incentive is not offered with respect to associated natural gas.[6]

Natural gas royalties would be zero percent when the contract price of natural gas is lower than or equal to US$5 per 1 million BTU. When the contract price of natural gas is higher than US$5.00 but lower than US$5.50 per 1 million BTU, natural gas royalties would generally range approximately between 0.1 percent and 5.4 percent.[7] When the contract price of natural gas is equal to or higher than US$5.50 per 1 million BTU, royalties would increase, starting from 5.5 percent at a price of US$5.50, depending on the contract price of natural gas.[8]

In establishing royalty rates, the variations in the US Producer Price Index shall be "considered," pursuant to rules to be published by the Ministry of Finance.

d. *Payment that Consists of a Percentage of Operating Profits Or the Contract Value of Hydrocarbons*

Finally, the license contracts shall provide for a payment to be established on a contract-by-contract basis by the Ministry of Finance, depending on the type of project, consisting of a percentage of:

- Operating profits or
- The contract value of hydrocarbons.

Pursuant to the Hydrocarbon Revenues Law, this payment will be the economic factor to be evaluated in the bid offers for the award of E&P contracts. Pursuant to the statement of intent, this payment (percentage of operating profits or contract value of hydrocarbons) is the principal mechanism by which the Nation will obtain economic benefits from hydrocarbon production.

The operating profits shall be calculated by subtracting the following amounts from the contract value of the hydrocarbons produced: (i) the royalty amount paid by the contractor in the corresponding month and (ii) the capital and operating costs and expenses incurred in the corresponding month, as well as the proportional part of the investments that are required for the execution of the particular E&P contract.

For purposes of calculating the operations profits, the Hydrocarbon Revenues Law establishes a 10-year carry forward of the costs, expenses and deductions that exceed the contract value of hydrocarbons minus the royalties effectively paid. Such deductions shall be applicable only in regard to the corresponding E&P contract and may not be consolidated with other E&P contracts in Mexico (ring-fencing). The Ministry of Finance may establish deduction limits per each applicable period.

The proposed Hydrocarbon Revenues Law establishes the special depreciate rates[9] that shall be applicable for oil and gas activities, instead of the depreciation rates established by the Mexican income law.

Whether a particular license contract will include a payment that consists of a percentage of operating profits or the contractual value of hydrocarbons will depend on the type of project. The statement of intent indicates that the payment of operating profits minimizes the conflicts between prices and costs. Calculating operating profits will be similar to calculating taxable income for income tax purposes and will require significant administrative resources from the State. The statement of intent indicates that the State does not currently have sufficient institutional capacity to administer and audit contributions based on a percentage of operating profits. The statement of intent indicates that the payment based on operating profits is not convenient for shale gas operations because auditing operating profits might disturb operations or increase the contractor's costs; therefore, the payment based on the contract value of hydrocarbon is more adequate for shale gas operations.

The license contracts will include an adjustment mechanism for these rates so that the Mexican state "may capture the extraordinary profitability" from production. It is unclear

what this adjustment consists of and whether it could somehow limit the market price upside for the contractor.

Clearly, a license regime in which payments to the state are based on the contract value of hydrocarbons produced, rather than on a percentage of operating profits, would be simpler to administer. A profit-sharing regime requires significantly more administrative resources from the host government. On the other hand, a payment regime based on the contract value of hydrocarbons could limit the market price upside necessary for the undertaking of certain risks and investments. Notably, the proposed laws do not provide for committed work programs to be evaluated as part of the contractor's offer, which is a preferred practice in other jurisdictions that usually causes contractors to embark on higher investment risks that are beneficial for the host country.

ii. Profit-Sharing and Production-Sharing Contracts

Pursuant to the Hydrocarbon Revenues Law, profit-sharing and production-sharing contracts shall establish the following payments in favor of the Nation: (i) exploratory phase fees, (ii) royalties and (iii) a payment that consists of a percentage of operating profits. As consideration, the contractor has the right to recover costs pursuant to rules to be issued by the Ministry of Finance, and to receive a payment, or a share of production, depending on the type of contract, that will consist of the balance of the operating profits after paying the specified percentage of operating profits to the Nation.

The exploratory phase fees and royalty provisions applicable to profit-sharing and production-sharing contracts are the same as those applicable to license contracts.

In profit-sharing contracts, the contractor will deliver all of the production to the marketing firm retained by the CNH, which shall deliver the sale revenues to the Mexico Oil Fund. The Mexico Oil Fund shall retain the amounts belonging to the Nation, and shall pay the contractor its share of profits in cash on a monthly basis.

In production-sharing contracts, the contractor retains in-kind production with a value equal to the recoverable costs and its share of operating profits. The share of production equivalent in value to the State's profits is delivered to the marketing firm retained by the CNH.

These contracts will include an adjustment mechanism for the profit split rates, so that the Mexican state "may capture the extraordinary profitability" from production. It is unclear what this adjustment consists of and whether it could somehow limit the market price upside for the contractor.

iii. Service Contracts

In service contracts, contractors will deliver all production to the State, and payments shall only be in cash as established in each contract. Exploratory fees and royalties will not apply to service contracts. Payment to the contractor shall be made by the Mexican Oil Fund with the proceeds from the marketing of the production derived from each corresponding service contract.

E. PEMEX PARTICIPATION IN E&P CONTRACTS

The proposed Hydrocarbons Law establishes that PEMEX may participate in tender processes for E&P contracts (after the Round Zero process) and may freely enter into joint ventures with private parties to participate in those tender processes. Unlike in entitlements migrated to E&P contracts, when PEMEX is granted an E&P contract in a competitive tender process, PEMEX, like any other private party, would be able to assign its rights and obligations under such E&P contract to another party under the terms established by the law.

Pursuant to the proposed Hydrocarbons Law, SENER **may** establish, within the bidding terms

of E&P contracts, that PEMEX's participation in a contract is required in the following cases:

- Where PEMEX has an entitlement that coexists, at a different depth, with an offered contract area;
- Where there are opportunities to foster the transfer of knowledge and technology for the development of the capabilities of PEMEX or another State Productive Enterprise (up to a maximum 30 percent required participation); and
- For projects that are to be supported by a specialized financial vehicle from the Mexican state, such as the Mexico Oil Fund (up to a maximum 30 percent required participation).

SENER **shall** establish, within the bidding terms of E&P Contracts, that PEMEX is to have a required participation:

- Where there is a possibility of discovering an international transboundary deposit (with a minimum required participation of 20 percent).

In regard to PEMEX's required participation when there is the possibility of discovering an international transboundary deposit, the statement of intent of the Hydrocarbons Law states that "the main purpose of this provision is to guarantee that, where there is a transboundary deposit, the natural resources would not be produced only to the benefit of the other nation, but will be shared with the Mexican state pursuant to the corresponding international treaty."[10]

F. NATIONAL CONTENT

The proposed Hydrocarbons Law provides that SENER, with the favorable opinion of the Ministry of Economy, shall establish a minimum percentage of national content in each entitlement and E&P contract. Transitory article 25 of the proposed Hydrocarbons Law establishes that the minimum average percentage of national content for E&P activities shall increase gradually starting from 2015, reaching at least 25 percent by 2025.

The percentage of national content required shall be established in the bidding terms of E&P contracts. The Ministry of Economy shall establish the measurement methodology for national content entitlements and E&P contracts and shall monitor contractor compliance. The entitlements and E&P contracts will include specific penalties for not complying with the national content requirements.

The constitutional reform and the proposed Hydrocarbons Law establish that the national content requirements shall be applied without prejudice to the international treaties entered into by Mexico. Free trade agreements often contain a "national treatment rule," which generally establishes that the host country needs to offer the same treatment to investors from treaty parties as it does to national investors. Mexico has 12 free trade agreements involving 44 countries. These include agreements with the United States and Canada under the North American Free Trade Agreement (NAFTA), Chile, Colombia, Costa Rica, Nicaragua, Peru, Guatemala, El Salvador, Honduras, Israel, Japan and the European Union.

G. INFORMATION FROM E&P ACTIVITIES

The proposed Hydrocarbons Law establishes that Mexico owns all geological, geophysical, petro-physical and petrochemical information, as well as the information obtained from geological surveys and E&P activities that are carried out by PEMEX, any Productive State Enterprise or private parties. The CNH will establish and administer the National Center of Information, which shall keep and publish information and statistics relating to hydrocarbons.

Contractors will be required to deliver to the CNH information obtained in their surveys and surface exploration. The CNH shall keep this information confidential. The CNH may contract

with third parties to conduct surveys and subsurface (seismic) exploration.

III. Midstream and Downstream Sectors

As noted above, all midstream and downstream hydrocarbon activities are to be regulated by permits issued by SENER or the Energy Regulatory Commission.

A. PERMITS

The following activities will require a permit from SENER:

- Treatment and refining of petroleum;
- Processing of natural gas;
- Import and export of crude oil, natural gas, liquefied petroleum gas, petroleum products and petrochemicals; and
- Non-pipeline transportation and storage of liquefied petroleum gas, as well as its distribution and retail sales.

The following activities will require a permit from the Energy Regulatory Commission:

- Transportation, storage, distribution, compression, liquefaction, decompression, regasification and retail sale of crude oil, natural gas, petroleum products and petrochemicals and
- Pipeline transportation and storage of liquefied petroleum gas.

The proposed Hydrocarbons Law establishes that no permit shall be required to market hydrocarbons (conducting retail sales of hydrocarbons does require a permit), liquefied petroleum gas, petroleum products and petrochemicals, but marketers will need to register with the Energy Regulatory Commission, submit any information requested and follow general regulations. The proposed Hydrocarbons Law includes provisions relating to the application process, suspension, revocation and other general terms relating to permits.

Pursuant to the transitory articles of the proposed Hydrocarbons Law, any party that currently engages in transportation, storage, distribution and retail sales, in accordance with the applicable legislation and regulations, and which does not have a permit granted by the Energy Regulatory Commission or by SENER, will need to apply and obtain a provisional permit to continue its activities within 3 months of the enactment of the Hydrocarbons Law.

B. NATIONAL CENTER OF NATURAL GAS CONTROL

As provided in the constitutional reform, 12 months after the enactment of the proposed Hydrocarbons Law, the National Center of Natural Gas Control (CENAGAS) shall be established. CENAGAS will have, at the outset, a dual function: it will acquire from PEMEX, and own and operate all of PEMEX's gas transmission pipeline and storage facilities, and it will be the independent manager of the "National System for the Integrated Transportation and Storage of Natural Gas."

The National System for the Integrated Transportation and Storage of Natural Gas will be comprised of the natural gas transmission pipeline and storage facilities, and compression, liquefaction, decompression, regasification and other related infrastructure owned by CENAGAS and owned by private parties that desire to interconnect them.

CENAGAS will provide transmission and storage services with the facilities it owns. CENAGAS will carry out tender processes for the expansion of the National System for the Integrated Transportation and Storage of Natural Gas, and, in exceptional cases, carry out such expansion itself.

C. OPEN ACCESS AND COMPETITION FOR MIDSTREAM ACTIVITIES

The proposed Hydrocarbons Law establishes that all permit-holders providing transportation, distribution or storage service shall provide open

and non-discriminatory access to their facilities, subject to capacity, and pursuant to rules to be issued by the Energy Regulatory Commission.

To incentivize competitive prices for consumers and competition between market players, the Hydrocarbons Law provides for a separation of the activities related to natural gas transportation and marketing. Accordingly, the proposed law establishes that private parties holding permits:

- Will not be able to market hydrocarbons that have been transported or stored in the private party's systems, except in emergency operational situations, unforeseen circumstances or *force majeure* (to avoid the conflict of interest that arises when a party holding a transportation or storage permit is competing with marketing companies that should be granted open access);
- May only provide services to parties that evidence the ownership of the product;
- May only transport and store products they own to the extent this is necessary for the operation of their systems; and
- May only transport and store products they own in a percentage of capacity determined by the Energy Regulatory Commission in the corresponding permit.

The Hydrocarbons Law establishes that parties engaged in the marketing of natural gas may participate, directly or indirectly, in the stock capital of related parties holding pipeline transportation and storage permits, provided they do not exceed the limits to be issued by the Energy Regulatory Commission.

The proposed Hydrocarbons Law's transitional provisions establish a gradual approach to reducing the concentration of natural gas marketing and pipeline transportation activities. Specifically, within five years of the law becoming effective, no participant may have more than 50 percent of the natural gas marketing sector or more than 50 percent of the natural gas pipeline transportation capacity. Within 10 years, no participant shall have more than a 20 percent participation in those sectors.

D. RETAIL SALES

The proposed Hydrocarbons Law would provide that retail sales of natural gas will be regulated by the Energy Regulatory Commission and shall be conducted at the processing or injection points. PEMEX may continue marketing natural gas, provided that service costs are transparent.

The transitory provisions of the law provide that the Energy Regulatory Commission will continue to regulate the retail sale of crude oil, natural gas, liquefied petroleum gas, petroleum products or petrochemicals, until the Federal Economic Competition Commission declares that there are effective competitive conditions in the retail sale of these products in the relevant markets.

The transitory provisions also establish the following transitional regime for the retail sale of petroleum products:

- Starting on January 1, 2017, permits for the retail sale of gasoline and diesel fuel can be granted by the Energy Regulatory Commission. Also starting from such date, PEMEX will not be able to condition the supply of gasoline and diesel fuels to the entering into of a franchise contract with PEMEX.
- The duration of gasoline supply contracts that are entered into with PEMEX after the date the Hydrocarbons Law comes into effect will not extend beyond December 31, 2017.
- Until December 21, 2018, permits for the importation of gasoline and diesel fuel will only be granted to PEMEX. After this date, such importation permits may be granted to any interested party that complies with the applicable legal provisions.
- Starting on January 1, 2019, retail sales of petroleum products may be carried out, and participants may establish their own service

stations and supply petroleum products from any source, whether it is gasoline or diesel.

- Gasoline and diesel prices shall increase in a controlled manner through the end of 2014. Starting from 2015, and until December 31, 2019, gasoline prices shall be adjusted for inflation by the Ministry of Finance on a monthly basis. After 2020, maximum prices for gasoline and diesel will be determined pursuant to law.

IV. Anticorruption, Transparency and Penalties

Pursuant to the proposed Hydrocarbons Law, SENER, the Ministry of Finance and the CNH shall publish information on a monthly basis relating to contract areas offered, E&P contracts and entitlements granted, permits approved, oil revenues received by the Nation and payments made to contractors, among other information.

The Hydrocarbons Law also contains a specific chapter for anticorruption and transparency, providing that any person (private party or public official) who conducts "corrupt acts" shall be sanctioned. Corrupt acts shall also constitute termination events of entitlements, E&P contracts, permits, etc.

The proposed Hydrocarbons Law includes a chapter establishing specific fines for State Productive Enterprises and private parties participating in the Mexican hydrocarbon sector. Depending on the subject matter, these fines may be imposed by SENER, the Ministry of Finance, the CNH, the Energy Regulatory Commission or the National Agency of Industrial Security and Environmental protection.

V. Land Issues

Both the constitutional reform and the proposed Hydrocarbons Law establish that hydrocarbon activities are public interest activities, which shall prevail over any other activity that requires surface or subsoil use. Accordingly, the Hydrocarbons Law authorizes the government to impose easements, and to occupy, use and expropriate private property, in connection with the performance of hydrocarbon activities.

The consideration for the purchase, use or occupation of land, goods or rights that are necessary for conducting E&P activities shall be negotiated directly between the owners of the affected land, goods or rights and the State Productive Enterprise holding an entitlement, or the contractor holding an E&P contract, as applicable. The Hydrocarbons Law establishes a detailed process by which such negotiations shall be conducted.

The consideration paid to the owners shall be proportionate to the particular "need" of the State Productive Enterprise holding an entitlement or the contractor holding an E&P contract in regard to the affected land, good or right. The consideration may include cash or in-kind payments, including contributions to local programs. However, because the hydrocarbons below the surface belong to the State, the consideration shall not include any hydrocarbon-associated payment. The agreements reached shall be public.

The Institute of Administration and Appraisals of National Assets (*Instituto de Administración y Avalúos de Bienes Nacionales*), a State entity in charge of administering national assets, shall establish and maintain data regarding the average prices for the use, occupation or purchase of land, which data shall serve as a starting point for negotiations.

If the parties do not reach an agreement within 90 days, the State Productive Enterprise holding an entitlement or the contractor holding an E&P contract, as applicable, may (i) request a district judge to grant a "legal hydrocarbon easement" or (ii) request the Institute of Administration and Appraisals of National Assets to conduct a mediation pursuant to a specific process established in the same law. If the parties do not

reach an agreement, SENER shall then propose to the executive branch the establishment of a legal hydrocarbon easement or expropriation of the corresponding land, good or right.

The legal hydrocarbon easement is a new legal concept established by the Hydrocarbons Law that can be established judicially (by a competent judge) or administratively (by the executive branch).

The legal hydrocarbon easement comprises the following rights:

- Transit right of persons;
- Transportation, handling and storage of all kinds of construction materials, vehicles, equipment and goods; and
- Construction, installation or maintenance of infrastructure or carrying out works necessary for the development or monitoring of the activities contemplated in an entitlement or E&P contract.

The legal hydrocarbon easement shall not exceed the duration of the respective E&P contract or entitlement. The proposed Hydrocarbons Law provides a mechanism to establish the consideration for each legal hydrocarbon easement.

VI. Social Issues

In regard to social issues, the proposed Hydrocarbons Law establishes that, prior to the granting of any entitlement or bid publication for an E&P contract, SENER, in coordination with the Ministry of Interior (*Secretaría de Gobernación*) and other competent authorities, shall conduct a social impact study in regard to the relevant area. The results of such study shall be made available to the entitlement holder or bid participants. SENER shall inform entitlement holders and contractors about the presence of vulnerable social groups in the corresponding areas, with the stated purpose of protecting the rights of those groups. In addition, SENER, in coordination with the Ministry of Interior, shall carry out a consultation process, and any other necessary activity, to protect the rights of vulnerable social groups.

SENER, with the favorable opinion of the Ministry of Finance, may establish, in entitlements or in bid terms, the amounts and other obligations that an entitlement holder or contractor shall contribute for the sustainable development of local communities in the areas of health, education and labor, among others.

Likewise, the persons interested in obtaining a permit for midstream and downstream projects shall deliver to SENER a social impact evaluation regarding the impact of their proposed activities as well as the corresponding mitigation measures.

Finally, the National Agency for Industrial Safety and Environmental Protection, to be established pursuant to the reform, shall issue the rules regarding safety and environmental matters.

VII. Key Tax Provisions

The proposed Hydrocarbon Revenues Law establishes the following key tax provisions applicable to hydrocarbon activities:

- Profits of entitlement holders or contractors are not subject to mandatory employee profit sharing;
- A "permanent establishment" for income tax purposes is created when a non-resident company carries out oil and gas activities in Mexico for more than 30 calendar days in any 12-month period (a significantly lower threshold than the 183 day requirement established by the general income tax law);
- Salary payments to non-resident employees paid by a non-resident employer without a permanent establishment in Mexico for services rendered in Mexico related to oil and gas activities for more than 30 days in any 12-month period are subject to individual income tax payments (a

significantly lower threshold than the 183 days established by the general income tax law).

It is important to note that, under the 2014 tax reform in Mexico, holding companies are generally no longer permitted to file consolidated tax returns.

In addition to the tax provisions contained in the Hydrocarbon Revenues Law, persons carrying out hydrocarbon activities will be subject to the ordinary Mexican tax laws.

VIII. Conclusion

The proposed Hydrocarbons Law and Hydrocarbon Revenues Law establish a new legal framework for hydrocarbon-related activities in Mexico. These bills are yet to be addressed and negotiated in Congress, and there may be significant changes made before they are approved.

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Endnotes

1 The proposed Hydrocarbons Law would repeal the Regulatory Law of Constitutional Article 27 of the Energy Sector (*la Ley Reglamentaria del Artículo 27 Constitucional en el Ramo del Petróleo*), enacted in 1958.

2 E&P "concessions" have been banned by the Mexican Constitution since the oil expropriation of 1938. Although the Constitution does not define the E&P concession, this term has historically implied having certain ownership rights to the hydrocarbons in place. The reform establishes a contractual framework that includes "licenses," which is not clearly differentiated from the term "concession." This issue could give rise to constitutional challenges.

3 Pursuant to article 28 of the Mexican Constitution, E&P activities, as well as planning and control of the national electric system and the transmission and distribution of electricity, are considered strategic. Thus, any State involvement in this sector shall not be considered a monopoly. Notably, the other activities down the hydrocarbon chain (midstream and downstream) are not considered "strategic."

4 When the contract price of crude oil is equal to or greater than US$60 per barrel, the following formula would be applied:

Royalty rate = [(0.125 x crude oil contract price) – 2.5]%

5 The following royalties shall apply to condensates: (i) when the contract price of the condensates is lower than US$60 per barrel, a 5 percent royalty rate shall be applied and (ii) when the contract price of the condensates is higher than or equal to US$60 per barrel, the following formula should be applied:

Royalty rate = [(0.125 x crude oil contract price) – 2.5]%

6 The proposed formula to determine the royalties applicable to associated natural gas:

$$\text{Royalty rate} = \frac{\text{Natural gas contract price}}{100}$$

7 When the contract price of natural gas is higher than US$5.00 but lower than US$5.50 per 1 million BTU, the following formula is applied:

$$\text{Royalty rate} = \frac{(\text{Natural gas contract price} - 5) \times 60.5}{\text{Natural gas contract price}}$$

8 When the contract price of natural gas is higher than or equal to US$5.50 per 1 million BTU, the following formula is applied:

$$\text{Royalty rate} = \frac{\text{Natural gas contract price}}{100}$$

9 The following depreciation rates are specified for oil and gas activities:

- 100 percent of the original amount of investments in exploration, improved and enhanced oil recovery, and non-capitalized maintenance, in the fiscal year in which they are carried out;
- 25 percent of the original amount of investments in development and exploitation of crude oil and natural gas deposits, in each fiscal year; and
- 10 percent of the original amount of investments in essential storage and transportation infrastructure for the execution of the contract, such as oil and gas pipelines, terminals, transportation or storage tanks that are necessary to take the contract production to the delivery, measurement and auditing points that are determined in each contract, in each fiscal year.

[10] On February 24, 2012, the United States and Mexico entered into a Transboundary Reservoir treaty, which has been ratified by both countries.

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