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Client**Alert**

Energy, Infrastructure and Project Finance

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Energy Reform With Respect to Hydrocarbons

On August 11, 2014, a package of reforms to Mexico's secondary energy laws (the "**Energy Reform**") was published. This Energy Reform stems from the amendment to Articles 25, 27, and 28 of the Constitution and the corresponding inclusion of 21 temporary articles, which changes went into effect on December 21, 2013 (the "**Constitutional Reform**"). The aforementioned legal changes were enacted pursuant to the objectives established by the 2013–2018 National Development Plan.

In addition to the modification of various existing laws, the Energy Reform contemplates the issuance and publication of the following nine new laws:

(i) Hydrocarbons Act;

(ii) Hydrocarbon Revenues Act;

(iii) Petróleos Mexicanos Act;

(iv) Mexican Oil Fund for Stabilization and Development Act;

(v) Creation of the National Agency for Industrial Security and Environmental Protection of the Hydrocarbon Sector Act;

(vi) Electric Industry Act;

(vii) Geothermal Energy Act;

(viii) Federal Electricity Commission Act; and

(ix) Coordinated Regulating Energy Sector Agencies Act.

This Client Alert has the purpose of briefly analyzing the key provisions of the Hydrocarbons Act (the "**Act**" or the "**HA**") and the Hydrocarbon Revenues Act (the "**HRA**" or, together with the HA, the "**Hydrocarbon Reform**").

Scope of the Hydrocarbon Reform

The Constitutional Reform substantially modified the structure of the hydrocarbon industry in Mexico. Prior to this reform, the primary activities of the hydrocarbon industry were considered to be exclusively State activities and were, for the most part, exercised through the state-affiliated entity Petróleos Mexicanos and its subsidiary entities ("**Pemex**").

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The Constitutional Reform maintains the control of the State over the oil and gas industry, and preserves national ownership of Hydrocarbons (oil, Natural Gas, condensates, Liquid Natural Gas and methane hydrates) ("**Hydrocarbons**") in Mexico. However, it also lays the groundwork for the opening of the energy sector to investment by private entities ("**Private Parties**"). Through the Hydrocarbon Reform, the ability of the private sector to participate in the strategic activities of exploration and production of oil and other Hydrocarbons ("**Exploration and Production**" or "**E&P Activities**") is expanded, and certain contractual procedures have been established in accordance with which E&P Activities can be conducted ("**Exploration and Production Contracts**" or "**E&P Contracts**").

The purpose of the Hydrocarbon Reform is to implement the Constitutional Reform with regard to Hydrocarbons.

For ease of reference, this Client Alert has been divided into the following chapters:

I. Hydrocarbons;

II. Exploration and Production Activities (upstream activities);

III. Other activities related to the Hydrocarbon Industry (midstream/downstream activities);

IV. Issues regarding Real Estate

V. Tax and Financial Regime for Hydrocarbons

VI. Temporary Regime

I. Hydrocarbons

The HA abrogates the Regulatory Law of the 27th Article of the Constitution regarding Hydrocarbons, which had been in effect since 1958. The HA establishes two fundamental principles: (i) subsoil Hydrocarbons (including on the continental platform, in the exclusive economic zone located outside of territorial waters and in rock strata or deposits beneath the latter) are the direct, inalienable, and unconditional property of the Mexican State. Therefore, concessions cannot be granted with respect to Hydrocarbons; and (ii) Exploration and Production (upstream activities) activities with respect to Hydrocarbons are "strategic areas" for the State, and therefore are to be conducted by means of assignments ("**Assignments**") to a State Productive Company ("**State Productive Company**" or "**SPC**") or by means of E&P Contracts with the latter or with Private Parties.

With respect to the rest of the value chain of the hydrocarbon industry (i.e., the transportation and storage (midstream activities) and processing and marketing (downstream activities) of Hydrocarbons), such sectors are no longer deemed to be strategic activities, and as such may be opened to private investment via permits ("**Permits**") granted by the competent authority.

The purpose of the HA is to regulate two broad categories of industry activity:

(i) E&P Activities (*upstream activities*). Those activities described as strategic for the Mexican state, which must be carried out exclusively through a) Assignments conferred to Pemex or another SPC; b) via the signing of an Exploration and Production Contract with Private Parties; or c) with the involvement of both an SPC and Private Parties. These activities in turn are classified as follows:

- Exploration and Production, and
- Surface Exploration and Surveying[1].

(ii) Other Hydrocarbon industry activities (*midstream/downstream activities*). Other activities related to the hydrocarbon industry including the following:

- The Treatment[2] and refining of oil, the Processing[3] of Natural Gas, the exportation and importation of Hydrocarbons and Other Petroleum Products[4], and
- the transportation, storage, distribution, compression, liquification, decompression, regasification, marketing, and Sale[5] of Hydrocarbons Oil Products, or Petrochemicals[6] to the Public, as well as the management of Integrated Systems[7].

1 Evaluation studies making use solely of activities on the surface of the land or sea with the purpose of evaluating the possible existence of Hydrocarbons in a particular area. These activities include the acquisition, processing, reprocessing, or interpretation of relevant information.

2 Treatment of Oil involves all industrial processes conducted outside of the Contractual Area or outside the Assignment Area, and that occurs prior to refining.

3 Separation of Natural Gas from other gases or liquids for their transformation or marketing

4 Products obtained from the refining of oil or from the processing of Natural Gas, and which derive directly from Hydrocarbons. These include gasoline, diesel fuel, kerosene, fuel oil, and Liquefied Natural Gas, among other products (but are distinct from Petrochemicals).

5 The direct retail sale to the consumer of Natural Gas or Oil Products, among other fuels in facilities with specific or multimodal purposes (including for service stations, compression, and carburation, among other uses).

6 Liquids or gases obtained from the processing of Natural Gas or the refining of oil and its transformation, and which are typically used as primary materials for industrial processes.

7 Pipeline, transportation and storage systems, which are grouped for the purpose of assessing tariffs, and which allow for operational coordination among various different installations.

II. E&P Activities (*Upstream Activities*)

The HA provides for various different contractual models tailored to the various types of activity that are to be carried out.

A. Assignments

Initially, Assignments derive from "Round Zero,"[8] which has been set forth in the Constitutional Reform to properly balance the resources that Pemex will manage going forward against those that the State will administer and for which the State will later issue tenders. This period will give PEMEX an opportunity to exercise its rights over those fields in which it has already made exploration investments, as well as over those that are currently in Production (mainly in shallow waters).

E&P Activities regarding Hydrocarbons will be conducted by Pemex or any other SPC (in exceptional cases) by means of an Assignment title.

- Assignments will be granted through the Ministry of Energy ("**SENER**"), following the issuance of a favorable opinion by the National Hydrocarbons Commission ("**CNH**").
- At a minimum, Assignment titles should contain the following: (i) the Assignment Area;[9] (ii) terms and conditions that must be observed during Exploration and Production; (iii) conditions and mechanisms for the reduction or reversion of the Assignment Area; (iv) the effective term of the Assignment and conditions for its extension; (v) guarantees and insurance; (vi) minimum national content requirements; and (viii) the deadline for presenting the Exploration Plan or Development Plan for Production to the CNH, as applicable.
- In order to comply with the Assignments granted to Pemex and other State Productive Companies, these entities may enter into service contracts with Private Parties for the operational implementation of the activities contemplated by such Assignments, provided that the consideration provided by such Private Parties is paid in cash.
- Pemex, or another State Productive Company, may only transfer an Assignment with the prior authorization of SENER, and provided that the transferee is another State Productive Company.
- SENER may revoke an Assignment grant and retake the Assignment Area if (i) the assignee has suspended its activities in the Assignment Area for more than 180 continuous days, or (ii) the assignee does not comply with the authorized plan for exploration and development, among others reasons for revocation. As a result of a revocation, the assignee shall transfer the Assignment Area to the State, without any charge, payment, or compensation whatsoever to the Assignee. Such Assignment Area must be in good condition.
- Pemex and any other State Productive Companies may request that SENER transfer the Assignments to E&P Contract holders. In the event of such a transfer, Pemex or the relevant State Productive Company may enter into partnerships or agreements with Private Parties. In such case, the private partner shall be selected through a bidding process.
- The Assignees have the right to include the benefits anticipated to arise from the Assignment in their financial statements for accounting and financial purposes.

B. Exploration and Production Contracts

1. General Provisions

- The Constitutional Reform provides for four contractual procedures by which Private Parties are able to participate in the hydrocarbon sector, specifically: (i) licenses; (ii) profit-sharing contracts; (iii) Production-sharing contracts, and (iv) service contracts. Similarly, the Reform establishes the circumstances under which multiple such contracts can be entered into in combination.
- Under the HA, the State, through the CNH, may enter into E&P Contracts individually and directly with Private Entities. The selection of said contractor ("**Contractor**") must be carried out by way of a bidding process, in accordance with the technical and economic guidelines issued by SENER and the Secretary of Housing and Public Credit ("**SHCP**"), respectively.
- Pemex and other SPCs may participate individually or through alliances or partnerships with Private Parties in the bidding process for E&P Contracts. Such alliances are intended to result in negotiations with respect to the sharing of costs, expenses, investments, risks, profits, Production and other responsibilities and benefits.

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8 The Round Zero consists of a phase included in the temporary regime established by the Constitutional Reform, the purpose of which is to grant Pemex preferential treatment for requesting Assignments from SENER for Exploration and Production in those areas where it would like to continue work, in order to achieve a balance between the resources to be operated by Pemex and the resources to be managed and tendered by the State. The deadline for SENER to resolve such request from Pemex is September 17, 2014.

9 The surface area and depth determined by SENER, as well as the geological formations contained within the vertical projection of said surface for said depth, in which the exploration and Production of Hydrocarbons is to take place.

10 The surface and depth determined by SENER, as well as the geological formations contained within the vertical projection within said surface area for said depth, within which the exploration and Production of Hydrocarbons will be realized by way of the execution of E&P Contracts.

- Also, if a Private Party which has been awarded an E&P Contract subsequently wishes to totally or partially transfer control of its operations within the Contractual Area[10], such transfer will require the authorization of the CNH.
- The bidding processes may allow for the possibility of participation by Pemex or any State Productive Company, in the percentages and based on the criteria below:

  (i) in any percentage, when the Contractual Area subject to the bidding process overlaps, to any extent, including at a different depth, with an Assignment Area;

  (ii) up to a maximum of 30% (thirty percent), where there are opportunities to promote the transfer of knowledge and technology in furtherance of the development of the capabilities of Pemex or other State Productive Companies;

  (iii) up to a maximum of 30% (thirty percent), in the case of projects that are intended to be undertaken via the Mexican Oil Fund for Stabilization and Development (the "**FMP**"), or

  (iv) for a minimum of 20% (twenty percent), for Contractual Areas where there is a possibility of finding cross-border deposits.
- In the event that there is a possibility of discovering cross-border deposits, the mandatory participation of Pemex or another State Productive Company will be a minimum of 20% (twenty percent) of the required investment in the project. If a cross-border deposit is confirmed, it shall be subject to the provisions of international treaties.
- Any type of E&P Contract must include at least the following:

  (i) the Contract Area;

  (ii) the plans for exploration and development of production, including a deadline for their presentation;

  (iii) the minimum work and investment program, as appropriate;

  (iv) consideration payable under the HRA;

  (v) its effective term, as well as conditions for its extension;

  (vi) the grounds for termination of the contract;

  (vii) a minimum national content requirements, and

  (viii) an acknowledgment that Hydrocarbons, while in the subsoil, are the property of the State, and that consideration for the same shall be subject to the provisions of the HRA.
- Contractors will have the right to include the benefits anticipated to arise from the relevant E&P Contract in their financial statements for accounting and financial purposes.
- E&P Contracts must include grounds for termination and administrative rescission. Administrative rescission is a feature that continues to be allowed under the Act; however, valid grounds for recissionare effectively limited to unjustified suspensions, improper assignments, or failure to comply with the agreed plan for exploration or for the development of Production.

  As a result of an administrative rescission, a Contractor shall transfer to the State without any charge, payment, or compensation whatsoever the Contractual Area, as well as all of the buildings, facilities, equipment, and any other goods of a similar nature that are necessary for the realization of further Production activities within such area. Unrelated goods or items unique to the reclaimed area shall remain the property of the Contractor.
- E&P Contracts will be governed by Mexican federal law, and shall exclude possibility that such agreements might be subject to foreign law. Also, Spanish language arbitration is contemplated as an alternative dispute resolution mechanism, with the ruling of such arbitration to be binding upon the parties. Such arbitration requirement shall be applicable to any dispute, with the exception of a dispute related to administrative rescission.

C. Consideration for Exploration and Production Contracts

- The Hydrocarbons Act establishes that SHCP shall be responsible for determining the economic and fiscal criteria applicable to each E&P Contract, which must be included in the specifications provided during the bidding process for the award of the contracts.
- Different types of consideration will correspond to each type of contract; however, certain types of consideration will be common between license contracts, production-sharing contracts and profit-sharing contracts. These agreements shall be regulated in accordance with the following:

1. Elements of consideration that are common to License contracts, Production-Sharing contracts and Profit-Sharing contracts

- **Contractual Quota for the Exploratory Phase.** The Contractor shall provide monthly payments to the State on the basis of the size of the Contractual Area and provided that relevant E&P Contract is not in its Production phase (the "**Contractual Fee for the Exploratory Phase**"). This payment allows the State to begin receiving compensation, from the time of the finalization of the contract, in an amount equivalent to $1,150 (one

thousand one hundred and fifty pesos) per square kilometer of surface area during the first 60 (sixty) months of the contract, in an amount equivalent to $2,750 (two thousand seven hundred and fifty) pesos per square kilometer thereafter, with such payments ending upon the commencement of commercial Production within the Contractual Area.

- **Royalties.** The contractor shall provide monthly payments to the State, equivalent to a percentage of the "Contractual Value"[11] of the relevant Hydrocarbons (petroleum, Associated Natural Gas, Non-Associated Natural Gas and condensate) calculated in conformity with the following rules (the "**Royalties**"):

  (i) Petroleum:

  a) If the Contract Price of the Petroleum is less than US$48 (forty eight dollars) per barrel, a rate of 7.5%; and

  b) If the Contract Price of the Petroleum is greater than or equal to US$48 (forty eight dollars) per barrel, Rate = [(0.125 x Contract Price of the Petroleum) + 1.5]%.

  (ii) Associated Natural Gas:

  a) The rate applicable to the Associated Natural Gas will be the result of dividing the Contract Price of Natural Gas by 100 (one hundred).

  (iii) Non-Associated Natural Gas:

  a) If the Contract Price of the Natural Gas is less than or equal to US$5 (five dollars) per one million BTU, a rate of 0%;[12]

  b) If the contract price of Natural Gas is greater than US$5 and less than US$5.5 (five point five dollars) per one million BTU, the rate shall be calculated in accordance with the following equation:

  Rate =((Contract Price of the Condensates-5)×60.5)/ (Contract Price of the Condensates);

  c) If the Contract Price of the Natural Gas is greater than or equal to US$5.5 (five point five dollars) per one million BTU, the rate shall be calculated in accordance with the following equation:

  Rate =(Contract Price of the Condensates)/100.

  (iv) Condensates:

  a) If the Contract Price for the Condensates is less than US$60 (sixty dollars) per barrel, a rate of 5%, and

  b) If the Contract Price for the Condensates is greater than or equal to US$60 (sixty dollars) per barrel: Rate = [(0.125 x Contract Price of the Condensates)- 2.5]%

D. Licenses

- **Consideration applicable to License contracts.** The HRA provides that License contracts should contemplate the following forms of consideration:

  i) In favor of the Mexican State:

  a) the Contractual Fee for the Exploratory Phase;

  b) the Royalties;

  c) a signing bonus upon execution of the contract, which consists of an amount specified during the bidding process, and which is to be paid in cash by the Contractor to the Mexican State. This amount shall be independent of the profitability of the project; and

  d) consideration for the Contractual Value of the Hydrocarbons that are produced under the License contract. This consideration will be the primary mechanism for capturing petroleum revenues in favor of the State and, therefore, the determining factor or variable in the awarding such contracts.

  ii) In favor of the Contractor, the transportation of Hydrocarbons that have been extracted from the subsurface within the Contract Area, provided that they are compliant with respect to consideration payable to the State, pursuant to the terms of the relevant contract.

E. Profit-Sharing and Production-Sharing Contracts

In general terms, the most important difference between Profit-Sharing Contracts and Production-Sharing Contracts stems from the manner in which consideration is calculated and paid. In the first case the consideration is paid in cash, while in the latter case it is paid in kind, taking the form of a percentage of Hydrocarbons produced. Elements which these two types of contracts share are as follows:

11 The contractual value is calculated by multiplying, for the period in question, i) the price of respective hydrocarbon, by ii) the measured volume of the same produced. The hydrocarbon price shall be the market value, as determined in accordance with the mechanisms established in the relevant E&P Contract.

12 This function as a Production incentive.

- **Forms of consideration applicable to Profit-Sharing Contracts and Production-Sharing Contracts.** The HRA provides that Profit-Sharing Contracts and Production-Sharing Contracts must include the following forms of consideration:

  i) In favor of the Mexican State:

  a) The Contractual Fee for the Exploratory Phase;

  b) Royalties;

  c) consideration calculated by applying a percentage to the amount of Operating Profit[13]. This consideration is what distinguishes these two types of contracts.

  ii) In favor of the Contractor:

  a) Reimbursement for Costs[14]; and

  b) the remainder of the Operating Profit (after deducting the amount payable to the State).

  iii) In Profit Sharing Agreements, Contractors shall deliver all production to the marketer that has been selected by the CNH for such purpose. The marketer will then deliver the proceeds resulting from the marketing of such Hydrocarbons to the FMP, and the latter will reserve the portion belonging to the State and pay out to the Contractor consideration due to it under the relevant contract.

  iv) In a Production Sharing contract, the costs and the remainder of the Operating Profit are to be paid in kind to the Contractor, as a percentage of the Hydrocarbons equivalent to the amount due. Payment in favor of the State will work in the same way, namely, through payments in kind through delivery of Hydrocarbons produced, in an amount equivalent to the amount of the consideration payable. In the latter case, the Contractor shall deliver the relevant production to the marketer selected by the CNH, who in turn will deliver the proceeds resulting from its sale to the FNP.

- Award Process Variable

The HRA specifies that the contracts are to be awarded by a competitive bidding process and that the determining factor or variable in determining to whom a contract will be awarded shall in all cases be an economic variable. SHCP shall be responsible for defining, with respect to each bidding process, the determining factor or variable for such bidding process. In accordance with the specific circumstances applicable to each contract, a minimum value for the determining factor or variable that is acceptable from the State's perspective shall be established.

- Adjustment Mechanism

The rates applied to the Operating Profits or the value of Hydrocarbons shall, depending on the type of contract, be modified by an adjustment mechanism, which will be disclosed in the relevant bidding process specifications. The adjustment should be based on a measure related to the cumulative profitability of the contract at a given moment, providing a basis for adjustment of the consideration. This means that the greater the profitability of the contract, the greater the revenue that the State receives will be.

F. Service Contracts

The HRA also provides that the State may enter into service contracts for the Exploration and Production of Hydrocarbons. The minimum conditions for such service contracts include requirements for Contractors to deliver the entirety of the Hydrocarbon Production to the State, and that the Contractor's consideration will always be payable in cash. Such conditions shall be set forth in each contract, taking into account relevant industry standards.

G. Contracts with Structures other than those referenced within the Law

In accordance with the Constitutional Reform, the HRA specifies that contracts may be entered into whose structure is different from those described within the Law, provided that appropriate consideration is provided for in the contractual arrangements, and that such arrangements are consistent with the goal of maximizing State revenues.

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13 Operating Profit is calculated by subtracting from the Contract Value of the Hydrocarbons, (i) the amount of Royalties, and (ii) the recovery of costs and expenses incurred during the period, as well as deductions reflecting the investments necessary to perform the contract. To the extent that the costs, expenses and deductions corresponding to investments exceed the Contractual Value of Hydrocarbons, this is subtracted from the actual Royalties paid which can be subtracted from the 10 (ten) periods immediately subsequent to the current period in accordance with the guidelines issued by the SHCP, without such deduction being applicable to any other contract. Expenses must be recorded in an expense registry. Only expenses in the registry can eventually be reimbursed, as provided for under the relevant contract. Costs and expenses that the contractor may not deduct include the following: (i) financing costs; (ii) costs incurred that are the result of fraud or negligence by the Contractor or persons acting on behalf of the Contractor; (iii) costs and expenses incurred relating to easements, rights of way, temporary or permanent occupations, leasing or acquisition of land and any other analogous amounts; and (iv) Royalties and Contractual Payments for the Exploratory Phase, among others.

14 Production-Sharing Contracts may specify the exclusion of consideration relating to cost reimbursement, without prejudice to the obligations described within the terms of the contract.

H. Bidding Process for Awarding E&P Contracts

- The bidding process is the general procedure through which E&P Contracts will be awarded and executed. The bidding procedures must take into account certain technical guidelines and fiscal requirements that will be established in each case by SENER and SHCP. The bidding process should also take into account the type of contract, the determining factor or variable for the award, evaluation mechanisms and, as appropriate, amendments to its terms and conditions.
- The bidding process shall (except in the case of the coonversion from an Assignment to an E&P Contract) require a prior opinion of the Federal Competition Commission ("**COFECE**"), which shall prepare the mechanisms for the prequalification and selection of the winning bid. Such opinion must be provided within 30 (thirty) days of the date of the applicable solicitation to bid.
- Those interested in submitting proposals must comply with the prequalification criteria issued by SENER, pursuant to an opinion of SHCP.
- Bidding is not required in the case of a direct award of an E&P Natural Gas contract in connection with a mining concession. The Hydrocarbons Act provides that such contracts can be awarded directly to mining licensees, contracted exclusively for E&P Activities relating to Natural Gas contained within a vein of coal and produced together with such coal in area where mining activities are currently being conducted; provided that the mining licensee obtains a favorable opinion from the CNH with respect to their economic solvency and their technical, administrative and financial capabilities.

  The Exploration and Production of Hydrocarbons that are not associated with coal deposits, as well as the Exploration and Production of Natural Gas associated with coal located outside of the relevant mine, can only take place through an E&P Contract awarded by the CNH in the context of the standard bidding process.

I. Other E&P Activities

- **Surface Surveying and Exploration:** The CNH may contract with Pemex, any other State Productive Company or other public entity, any academic institution or any other person the right to conduct surface surveying and exploration activities, in exchange for consideration. Such activities shall take place within a specific surface area, in furtherance of determining the possible existence of Hydrocarbons within that area, with the understanding that these activities do not confer rights of exploration, nor preference with respect to the awarding of Assignments or E&P Contracts.

  All information obtained from surface surveying and exploration, as well as E&P Activities, carried out by Pemex, any other State Productive Company or by Parties, shall be owned by the Mexican State, and the collection, receipt, use, management, updating, and publication of this information shall be the responsibility of the National Information Center for Hydrocarbons.
- **Sales of Hydrocarbons Extracted under E&P Contracts:** The CNH, upon request of the Mexican Oil Fund for Stabilization and Development (FMP), may contract with Pemex, any other State Productive Company or a Private Party, through a public bidding process, to carry out the sale of Hydrocarbons obtained by the State as a result of E&P Contracts.

J. National Content component of E&P Contracts and Assignments

Beginning in 2015, E&P Activities carried out pursuant to Assignments and E&P Contracts must comply with a requirement to use at least 25% domestic content, which threshold shall increase to 35% in 2025. This requirement does not apply to projects in deep and ultra-deep waters; for such projects, national content requirements will be determined by the Ministry of Economy ("SE") with the opinion of SENER.

III. Other Hydrocarbon Industry Activities (*Midstream/Downstream Activities*)

A. Permits

In addition to E&P Activities, the HA contemplates a permitting policy for other activities that form part of the hydrocarbon industry, including industrial processing and logistics. It is expected that these permits will be issued by either SENER or the Energy Regulatory Commission ("CRE"), depending on the activity concerned, as follows:

- SENER shall issue Permits for the following activities:

  (i) treatment and refining of oil;

  (ii) Natural Gas processing; and

  (iii) exportation and importation of Hydrocarbons and petroleum.
- The CRE shall grant Permits for the following activities:

  (i) transportation, storage, distribution, compression, liquefaction, decompression, regasification, marketing and sale to the public of Hydrocarbons, petroleum and Petrochemicals; and

  (ii) management of Integrated Systems.

- The Permits may be assigned with the prior authorization of SENER and the CRE, as appropriate. Any assignment carried out without said authorization shall be null and void.
- Permits may terminate due to (i) the expiration of the period originally provided for in the Permit or its extension; (ii) waiver on the part of the Permit-holder, provided that third-party rights are not affected and (iii) expiration of the Permit (which shall occur after 365 consecutive days, where the Permit does not establish a different period), among other termination events.
- Permits may be revoked due to (i) non-compliance; (ii) unduly discriminatory practices detrimental to the end users; (iii) failure to observe prices and fees; (iv) assigning or encumbering Permits without the authorization of SENER or the CRE, as applicable, among other revocation events.
- The activities and services covered by such Permits are considered to be of public interest. However, as provided for by the Expropriation Law or for reasons of public interest, (e.g. war, natural disaster or an imminent danger to national security) the temporary occupation of a Permitted project by the Mexican State shall be allowed, but may not last more than 36 (thirty six) months.
- Should the supply of Hydrocarbons, petroleum or Petrochemicals related to the Permit become endangered for reasons attributable to the Permit holder, an intervention may be ordered. In this case the authority that issued the Permit shall take control of the administration and operation of the project in order to ensure the adequate supply and development of the resources for which the Permit was granted. The costs of the intervention shall be covered by the income of the Permit-holder. Such intervention shall not last more than 36 (thirty six) months.

B. Principle of open access in transportation, distribution and storage (Midstream Activities)

- The HA includes an open access principle in transportation, distribution and storage activities in order to ensure competition in these sectors. This principle entails that Permit-holders provide pipeline transportation and distribution services, as well as storage of Hydrocarbons, petroleum and Petrochemicals to third parties (provided they have available capacity that has not been contracted, or that is contracted but not in use). Permit-holders shall disclose this public information to third parties, and provide open access without any discrimination with regards to their facilities and services.
- Permit-holders with pipeline transportation and storage capacity that are subject to the open access requirement cannot dispose of or sell hydrocarbons, petroleum or Petrochemicals that have been transported or stored in their systems, except when such a disposal or sale would be necessary to resolve a situation with unforseeable circumstances or by force majeure. This prevents the potential conflict of interest between marketing and transportation activities, which can occur, for example, when a Natural Gas pipeline transmission Permit-holder competes with marketing companies whose access to infrastructure it must simultaneously ensure.
- Parties that have reserved capacity contracts with unused capacity should market it in the secondary markets, or place it at the disposition of independent managers (*gestores*) of the Integrated System, the transporter in charge of the pipeline or (when the corresponding facilities are not part of the Integrated System) the storekeeper. If third-party interests are implicated, said capacity must be offered by means of an Open Season[15] if the capacity release is permanent.

C. Integrated Systems

- The HA, in order to foster service, quality and safety improvements, provides that pipeline transportation and storage of Natural Gas, petroleum and Petrochemical systems may be interconnected, creating an Integrated System coordinated by an independent manager. This system serves to (i) ensure effective open and non-discriminatory access to transportation systems'; (ii) encourage the development of market centers and wholesale markets; (iii) ensure the balance of integrated system operation; and (iv) administer the secondary market of integrated system capacity, among other advantages.
- The CRE shall authorize this integration and issue Permits to the managers of each part of the Integrated System. These managers may be public entities, individuals or public-private partnerships. The managers must further be independent of persons carrying out Production, distribution and marketing activities for Natural Gas, petroleum and Petrochemicals.

D. National Center for Natural Gas Control

- The National Center for Natural Gas Control ("**CENAGAS**") shall be the independent manager of the National Integrated Natural Gas Transportation and Storage System and shall have the purpose of guaranteeing the continuity and safety of the supply of Natural Gas throughout the national territory.

15 A procedure regulated by the CRE that (in order to provide fairness and transparency in the allocation or acquisition of the available capacity of a system or a new project to third parties, as a result of a capacity waiver) shall be carried out by a Permit-holder for the transportation, storage or distribution of Hydrocarbons, oil and Petrochemicals in order to make them available to the public, with the purpose of allocating transmission capacity or determining capacity expansion needs.

- CENAGAS will provide transmission and storage services with the facilities that it owns. Likewise, CENAGAS will be responsible for bidding conducting bids relating to infrastructure projects for the National System for the Integrated Transportation and Storage of Natural Gas, under the terms set forth by SENER and subject to the CER's authorization of the bidding conditions.

IV. Real Estate Issues

A. Temporary Occupation and Use

- The Hydrocarbons Act sets forth that the hydrocarbon industry is a public interest and, accordingly, authorizes the imposition of legal easements and the occupation of land for the performance of hydrocarbon-related activities, pursuant to the applicable provisions equivalent to cases in which same is required by the State. E&P Activities are considered to be social welfare activities in the interest of the public, and, therefore, prevail over any other activity that may involve the use of the surface or subsoil of the land affected thereby.

- The consideration and the terms and conditions for the purchase, surface occupation and use of land, goods, or rights necessary for conducting E&P Activities shall be negotiated between the owners, possessors, or title-holders to the land, goods, or rights in question, and those entities holding the Assignments or the Contractors.

- Likewise, such consideration must include, as applicable: (i) compensation payments for goods or rights other than the land and an allowance for damages at market value; (ii) rent for occupation, easement, or use of the land at market value; (iii) if it is a commercial extraction project, a percentage of the total revenue, no less than 0.5% and no greater than 2% (or, in the case of a Non-Associated Natural Gas project, not less than 0.5% or greater than 3%).

- If there is no agreement within 180 calendar days following the day in which the Contractor notifies the land owner its intention to buy, the Contractor may request a competent Federal Court to establish a "legal hydrocarbons easement" in its favor. This type of easement includes transit by people and transportation and and storage of construction materials, vehicles, machinery and other kinds of goods. It also includes the right to undertake construction, installation and maintenance of appropriate infrastructure, undertaking work that is necessary for the proper operation and supervision of the corresponding E&P Activities, and any other works that may be necessary for such purposes. A legal hydrocarbons easement may not exceed the term of the corresponding E&P Contract or Assignment.

- The consideration payable for a legal hydrocarbons easement shall be determined by the competent Court taking into consideration, among other factors, any appreciation of the property (*plusvalía*), characteristics of the tracts of land and appraisals submitted by both parties.

V. Hydrocarbon Tax and Financial Regime

A. Tax on Hydrocarbon Exploration and Production Activities

Contractors shall be required to pay a tax on the Exploration and Production of Hydrocarbons for the Contractual Area defined in the applicable E&P Contract. Said tax consists of a fee per square kilometer covered by the Contractual Area; during the exploratory phase the fee will be $1,500 (one thousand five hundred pesos) and during the Production phase the fee will be $6,500 (six thousand five hundred pesos) pesos. The exploratory phase lasts from the formalization of the E&P Contract until commencement of the Production phase. The Production phase lasts from the start of activities targeted at commercial Production until the relevant contract has terminated. The aforementioned fees will be updated annually, on the first of January every year.

B. Income Tax-Related Tax Aspects

- **Deduction Percentages.** The HRA includes deduction percentages for: (i) investments made for exploration, secondary and enhanced recovery, and non-capitalizable maintenance; (ii) investments made for the development and Production of oil or Natural Gas, and (iii) investments made for the storage and transportation infrastructure necessary for performing the contract.

- In order to determine their income tax, Contractors must apply the following percentages:

  (i) 100% (one hundred percent) of the amount of the original investments made for exploration, secondary and enhanced recovery, and non-capitalizable maintenance, during the fiscal year in which they are made;

  (ii) 25% (twenty five percent) of the amount of the original investments made for the development of and Production of the relevant oil and Natural Gas deposits, every fiscal year; and

  (iii) 10% (ten percent) of the amount of the original investments made for the storage and transportation infrastructure necessary for performing the contract.

C. Transparency and Auditing. The Hydrocarbon Reform sets forth that the Ministry of Finance and Public Credit shall publish

information on the volume of Hydrocarbons produced, revenues derived from same, and the consideration paid to the Contractors, among other information, with regard to each contract, on a monthly basis, over the Internet.

D. Final Provisions. The HRA sets forth that a permanent establishment will be deemed to occur when a resident abroad performs the activities referred to in the Hydrocarbons Act within Mexico or in the exclusive economic area over which Mexico holds rights, for a total of more than 30 (thirty) days during any 12-month period.

VI. Transitory Regime

The transitory regime includes the following provisions, among others:

A. The executive branch shall issue applicable regulations in respect of the HA within the 180 calendar days of the date on which the Hydrocarbons Act enters into force. Existing regulations in connection with the Regulatory Law of Constitutional Article 27 relating to the Energy Sector, regulations on Natural Gas, and regulations on liquefied petroleum gas shall remain in force until the aforementioned regulations are issued, to the extent that they do not contravene the provisions of the Hydrocarbon Reform.

B. The following shall remain in force under the terms and conditions under which they were signed or awarded: i) the permits granted by SENER or the CRE to carry out hydrocarbon-industry activities before the Hydrocarbons Act entered into force, and ii) the contracts for works, services, supply, or operation signed by Pemex based on the Regulatory Law of Constitutional Article 27 of the Energy Sector.

C. No later than twelve months after the Hydrocarbons Act enters into force, the executive branch shall issue a decree creating CENAGAS, which will be responsible for operating the National System for Integrated Transportation and Storage. This decree will establish the organizational structure, procedures, and authority of that body. Likewise, it will provide for Pemex and its subsidiaries to immediately transfer to CENAGAS the resources it needs to fulfill is stated role.

Within 24 months after the Hydrocarbon Reform has entered into force, CENAGAS must have the budgetary and technical resources to carry out the tender process for necessary infrastructure projects for the National System for the Integrated Transportation and Storage of Natural Gas. Until such time, SENER may decide that State Productive Companies shall carry out such projects.

D. The Energy Regulatory Commission shall continue to subject first-hand sales (i.e., the first transfer of title within the national territory by Pemex and its subsidiaries, State Productive Companies, or any legal entity on behalf and by order of the State to a third party or among them) of Hydrocarbons, oil products, or Petrochemicals to asymmetrical regulation principles, with the goal of limiting Pemex's domination, in order to encourage the participation of more economic agents and to contribute to the efficient and competitive development of the markets.

E. With regard to the gasoline and diesel markets:

i) From the time that the Hydrocarbons Act enters into force until December 31, 2014, such markets will be governed pursuant to the provisions already in force, and starting from January 1, 2015 until December 31, 2017, prices will be set by the executive branch. Starting on January 1, 2018, prices will be set according to market conditions.

ii) Until December 31, 2016, only Pemex and its subsidiaries may obtain permits to import gasoline and diesel fuel. Starting on January 1, 2017, or earlier if market conditions allow it, permits for the importation of gasoline and diesel fuel may be awarded to any interested party that complies with the applicable legal provisions.

iii) Permits for the retail sale of gasoline and diesel fuel may be granted by the CRE starting on January 1, 2016.

iv) The term of supply contracts with Pemex that are signed after the Hydrocarbons Act has entered into force may not extend beyond December 31, 2016. Starting on January 1, 2017, Pemex, its subsidiaries, and its affiliates may enter into supply contracts
under the new market conditions. The supply contracts entered into by Pemex, its subsidiaries, or its affiliates may not be conditioned on the execution of franchise contracts, nor may they restrict the parties thereto from unilaterally terminating the contract at such time as conditions of effective competition exist (according to COFECE).

If conditions of effective competition exist (according to the COFECE) prior to the periods noted in this section, the periods set forth above will be shortened to the date of the corresponding declaration issued by the COFECE, at which time prices shall be determined by market conditions.

F. From the time that the Hydrocarbons Act enters into force, and continuing no later than December 31, 2015, permits for the importation of liquefied petroleum gas will only be granted to Pemex, its subsidiaries, and its affiliates. Starting on January 1, 2016, or earlier if market conditions allow it, the aforementioned permits may be granted to any interested party that complies with the applicable legal provisions.

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