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# Regulatory analysis and litigation strategy against the amendment to the Hydrocarbons Law reform

On March 26, 2021, President Andrés Manuel López Obrador presented before the Chamber of Deputies the Draft Decree reforming and adding several provisions to the Hydrocarbons Law, and parallel to such amendment, on April 20, 2021, that same Chamber presented the initiative to reform the thirteenth transitory article of the same law. Both legal reforms have already been approved, but while the first of these has already been published in the Federal Official Gazette, the second is still pending publication. Within this document we will analyze the content and scope of both legal reforms, as well as the general litigation strategy against them.

**1. Amendment to the Hydrocarbons Law, derived from the Draft Decree issued by the Mexican Republic President (the "Amendment")**

The Amendment was published in the Federal Official Gazette on April 4, 2021, entering into force the next day, and it will have significant repercussions throughout the value chain, therefore, we recommend that all parties that participate or intend to participate in the hydrocarbons sector (*downstream, midstream and upstream*[1]) analyze the impacts that this could have on their specific case, as well as the means of defense available to them to protect their rights and safeguard their regular operation. The following are the most relevant points of the Amendment:

*a) Minimum storage requirement*

The Amendment proposes to amend Article 51 of the Hydrocarbons Law ("**HL**") to include as a requirement for the granting of the permits indicated in Article 48 of the HL (treatment and refining of oil; processing of natural gas; export and import of hydrocarbons and petroleum products; as well as transportation, storage, distribution, compression, liquefaction, decompression, regasification, commercialization and sale to the public of hydrocarbons, petroleum products or petrochemicals; as well as transportation, storage, distribution, compression, liquefaction, decompression, regasification, commercialization and sale to the public of hydrocarbons, petroleum products or petrochemicals), to demonstrate that, "if applicable", it has the storage capacity determined by the Ministry of Energy ("**SENER**") through general rules.

It should be noted that according to the Public Policy of Minimum Storage of Petroleum Products (the "**Policy**")[2], the obligations of minimum storage of petroleum products would only apply to the activities of Distribution and Commercialization and not to the

1 Although this reform does not mention at any time exploration and extraction activities, we warn that this business may also suffer significant impacts, since this industry is an integral activity, in which the activities abovementioned could not be understood without being able to carry out the respective commercialization or export.
2 The Policy was published in the Mexican Official Gazette on December 12, 2017, and was modified through the same means on November 29, 2018, and December 6, 2019.

rest of the activities referred to in Article 48 of the LH. However, this new requirement is ambiguous, and it is not known if it would be applied only to Distribution and Commercialization activities, or to the rest of the permitted activities indicated in the aforementioned article, in which case, there would be gaps for its application, since, among other things:

- The Policy indicates that the storage level to be complied with is calculated based on the volume of purchases, sales and inventories of the last months. Nevertheless, it is not completely clear how it would be intended to be applied as an ex ante requirement for the granting of new permits.
- It would make no sense to require a minimum storage volume for some of the activities permitted under Article 48 of the LH, as would be the case for transporters or storage permits holders themselves.

It should be noted that non-compliance with storage obligations not only jeopardizes the granting of permits, but also threatens the conservation of those previously granted, since according to the Fourth Transitory Article, the competent authority must revoke those permits that, upon the entry into force of the Amendment, do not comply with the storage requirement determined by the SENER. As for the granting of new permits, it is not clear whether this revocation order would apply only to the case of Distribution and Commercialization permits that were already subject to compliance, or to the rest of the permits referred to in Article 48 of the LH.

Finally, it should be noted that the Policy allows for compliance with storage obligations through an alternative manner, i.e., by obtaining tickets (financial rights that cover the ownership of a certain volume of storage in a specific terminal). However, to date, the implementation of the Policy has been hindered by the lack of regulation, mainly with respect to the circulation of tickets at the national level, which intensifies the importance of all of the above.

*b) New grounds for revocation of permits.*

The Amendment proposes to include new grounds for revocation of permits, both in Article 56 of the HL, as well as in the Fourth (analyzed in the previous section) and Sixth Transitory Articles. The new grounds consist of: **i)** carrying out activities of Transportation, Storage, Distribution or Sale to the Public of Petroleum or Petrochemicals, when it is proven that these have been acquired illegally or through the commission of the crime of smuggling (the proposal covers both simple smuggling, as well as "technical smuggling" through which undervalued goods enter national territory seeking to omit the payment of a large part of the compensatory fee to the oversight body); **ii)** recidivism in non-compliance with the provisions related to the quantity, quality and measurement of hydrocarbons and petroleum products; **iii)** failure to comply with the obligations of minimum storage of petroleum products (as mentioned above, it is not clear if this cause will be applied only to Distribution and Commercialization permits, or to all those referred to in Article 48 of the Hydrocarbons Law), and **iv)** failure to comply with "*the corresponding requirements*" or "*that violate the provisions of the Hydrocarbons Law*".

We consider that while some of the grounds for revocation would be plausible (such as the one intended to combat "*huachicol*" and other improper practices), there are many others that generate uncertainty and violations of the rights of a large number of participants in this industry.

In addition, the Fifth Transitory Article of the Amendment reiterates that in terms of Article 55, section I, paragraphs a) and b) of the HL, the permits expire when the holders do not exercise the rights conferred within the term established therein, or in the absence of a term, for a consecutive period of 365 calendar days. In this regard, the Amendment orders the competent authority to deprive the legal effects of the permits that have any cause for expiration.

*c) Suspension, intervention or temporary occupation of permits.*

Before the Amendment, the LH already provided for the possibility of intervening and occupying permits, according to certain circumstances and for a maximum term of 36 months, now Article 57 of such Law is amended, establishing that in case of intervention or occupation, in order to guarantee the continuity of the operation in question, the authority may only contract productive companies of the State and no longer third parties with technical capacity, as it was previously allowed.

Likewise, the Amendment incorporates Article 59 Bis, to provide powers to the SENER or the Energy Regulatory Commission (the "**CRE**"), to order the suspension of the permits under its jurisdiction, in the event of "*imminent danger to national security, energy security or the national economy*", terms that are very subjective and changeable. The authorities in question must previously follow the administrative procedure indicated in the same article.

Although this figure of "suspension" is similar to the various pre-existing figures of "occupation" and "intervention", the fact is that the suspension incorporates certain particularities that generate uncertainty for the participants in this industry, among which the following stand out:

- The suspension will have the duration determined by the authority; however, unlike the pre-existing figures, where it was provided that the duration could not exceed thirty-six months, the suspension omits this text and provides that, once the term determined by the authority has expired, it will allow the revocation of the permit.

- It is noteworthy that in case of suspension, the competent authority (SENER or the CRE), "*will be in charge of the administration and operation of the Permit Holder*", instead of stating that it will only be in charge of the suspended permit.
- In the event of taking over the administration and operation, the authority may rely on the Permit Holder's personnel, hire a new operator, or a combination of these options, which shall be analyzed with the proposed amendment to article 57.
- It is not determined what will happen with the rights and obligations inherent to the suspended operation (such as the collection of profits, payment of expenses, compliance with reporting obligations, among others).

It should be noted that this part of the Amendment allows great discretion to the authorities and would give rise to authoritarian acts, since it does not define some important concepts, and does not establish specific criteria for the application of these measures or parameters to determine their duration.

Furthermore, in order to reverse the effects of the decreed suspension measure, it is necessary for the licensee to demonstrate that the causes that originated it (national security, energy security or national economy) have been remedied or eradicated, which by their nature, do not depend in any way on the acts or abstentions of the licensee. Moreover, in the last paragraph of the article in question, it is stated that if after the suspension period (which may have the duration indicated by the authority itself), the licensee "*is not in conditions to continue with its obligations*", the authority may revoke the permit in question.

*d) Payment of damages to potentially affected permit holders*

The Third Transitory Article of the Amendment indicates that the permit holders that could be affected may request "*the payment of the corresponding damages*". This provision is extremely relevant as it would seem to seek to safeguard the rights of the permit holders; however, it generates a lot of uncertainty:

- It is not clear whether it would apply only to cases of suspension or also for cases of intervention or occupation, since the latter two figures were already previously provided in the LH.
- It is uncertain what would be the procedure and formalities applicable to a payment of this nature, since: **i)** the compensation provided for in the Federal Law of Patrimonial Responsibility of the State would not apply, since there would be no "irregular" activity from the State, and **ii)** there are several obstacles to applying the Expropriation Law.

*e) Requests for assignment of permits in a negative sense (negativa ficta).*

The Amendment proposes to amend Article 53 of the HL to change the meaning of administrative silence, so that contrary to what happened previously, the SENER or the CRE (depending on the permit in question), when the term of 90 calendar days from the day following the day of receipt of the application for the assignment of a permit has elapsed without an express resolution from the competent authority, it will be understood to be resolved (fictitiously) in a negative or unfavorable manner for the applicant.

Thus, when the applications are resolved in a fictitious manner, the authorities would not be obliged to disclose the grounds and motives that would have led them to unfavorably resolve the application, unless the individuals file the respective means of defense. This situation would not necessarily violate Constitutional rights.

It should be noted that some of the provisions contained in the Amendment would violate rights contained in the Mexican Constitution, such as the rights to free competition and concurrence, to legal certainty (in its aspect of legitimate trust and acquired rights), to legality, to freedom of work and commerce, to equality, as well as those provided in the International Treaties to which Mexico is a party such as guaranteeing foreign investors fair and equitable treatment, treatment no less favorable than that of its own nationals or investors of a third State, compensation in cases of direct and indirect expropriation, among others.

We suggest that each company analyze the impact that the Amendment could have on their specific case and, if necessary, anticipate the respective means of defense. We consider that several of the provisions contained in the Amendment would affect a significant number of parties participating in this industry, since its entry into force. Therefore, it is necessary to keep in mind that these parties may file an *amparo indirecto* lawsuit within 30 days following the date of entry into force of the amendment in question, specifically, on June 16, 2021, the latest, through which the suspension of the application of this amendment could be required.

The necessary analysis of Reciprocal Investment Promotion and Protection Agreements ("**APPRI**") and International Trade Treaties - such as the Treaty between Mexico, the United States and Canada ("***T-MEC***") or the Comprehensive Progressive Agreement for Trans-Pacific Partnership ("***CPTPP***") - should not be overlooked, as it is important for the foreign investor to ensure that the national means of defense that is initiated does not conflict with or limit the possibility of eventually initiating an investor-State arbitration under the international investment protection treaty that applies.

**2. Amendment in connection with the elimination of asymmetric regulation to which Petróleos Mexicanos is subject, derived from the Draft issued within the Chamber of Deputies**

Parallel to all of the above, on April 20, 2021, the president of the Energy Commission of the Chamber of Deputies presented before the Board of Directors of said Chamber the Initiative with Draft Decree amending the Thirteenth Transitory Article of the LH (the "**Second Amendment**"), aimed at eliminating the asymmetric regulation to which *Petróleos Mexicanos* ("**Pemex**") is currently subject. That same day, the Second Amendment was approved in an extraordinary session by the Energy Commission, and on April 21, by the Plenary of the House of Representatives, with a result of 301 votes in favor, 147 against and 2 abstentions. The Second Amendment was approved by the Senate on April 29, 2021, and is expected to be published in the following days in the Federal Official Gazette.

It is worth remembering that said transitory article derived from the Constitutional reforms in energy matters at the end of 2013, which was aimed at guaranteeing that, in the value chain of hydrocarbons, petroleum and petrochemicals, market conditions were formed, where the private sector would effectively manage to concur and participate. In this regard, the Thirteenth Transitory Article of the LH empowered the CRE to subject First Hand Sales ("VPM") of hydrocarbons, petroleum products and petrochemicals to asymmetric regulation principles. The purpose of this was to limit the dominant power of Pemex, while achieving a greater participation of economic agents that would favor the efficient and competitive development of the markets. The regulation of the VPM by the CRE included the approval and issuance of the general terms and conditions, as well as the issuance of the methodology for the calculation of their prices.

Derived from the above, on December 16, 2019, the CRE issued Agreement A/043/2019, in which, alleging the existence of a greater participation of economic agents in the market, left without effect the methodology established for Pemex *Transformación Industrial* to determine the prices of VPM and in the storage terminals.

Notwithstanding the foregoing, since the Thirteenth Transitory Article of the LH remained in force, several asymmetric regulation measures also remained in force. Pursuant to the Second Amendment to said Transitory Article, such measures subject Pemex to disadvantages before its competitors, limiting its possibility of participating in equal conditions in the commercialization of hydrocarbons, petroleum products and petrochemicals.

By virtue of the foregoing, the Second Amendment establishes that since a greater participation of economic agents that favor the efficient and competitive development of the markets has been achieved, the power granted to the CRE to subject to asymmetric regulation principles the VPM of hydrocarbons, petroleum products or petrochemicals, as well as the commercialization carried out by persons controlled by Pemex or its subsidiaries, is no longer in effect. In addition, the Second Amendment provides that the sale carried out by Pemex, its subsidiary productive companies, or a legal entity, on behalf and at the order of the State, will be considered as commercialization in terms of the provisions of the LH and its Regulations, for which reason the principles of generality and non-undue discrimination provided therein must be observed.

Finally, the Second Amendment provides that, within 30 calendar days from the effective date of the reform, the CRE must annul the agreements, general administrative provisions, resolutions and guidelines related to the imposition of asymmetric regulation principles on Pemex and its subsidiaries.

We believe that the Second Amendment's justification for amending the Thirteenth Transitory Article is incorrect, since, as commented by the President Commissioner of the Federal Economic Competition Commission ("**COFECE**"), Alejandra Palacios, the amendment is based on the number of permits that have been granted to private parties, when in Mexico there is no intense competition in the wholesale market, based on what is really relevant, which is the volume of sales. According to the Commissioner, although different service stations of brands other than Pemex operate in Mexico, the latter continues to be the main supplier in the wholesale market by supplying, so far in 2021, 81% of the domestic fuels market and 71% of diesel.

**3. Conclusions**

We believe that both the Amendment and the Second Amendment will affect most of the parties involved in the hydrocarbons, petroleum products and petrochemicals value chain. Both amendments will generate great uncertainty in the sector in question, allowing authoritarian acts to take place, in addition to privileging the participation of Pemex, to the detriment of private parties. All of the above results in important Constitutional violations and violations of the rights derived from the International Treaties to which our country is a party.

Our administrative litigation team specializing in energy matters has significant experience in the processing of *amparo* proceedings of this nature, particularly in hydrocarbons, collaborating with our international litigation and arbitration team to present a comprehensive strategy that considers Mexico's international commitments to foreign investors. We remain at your disposal to schedule a call and review your particular situation.

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