Assessing the Outlook for Future Power Projects in Mexico - The Legal Framework

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I. Introduction.

Under the Mexican Constitution the ownership and exploitation of energy resources is reserved to the state, with the state-owned enterprises Petroleos Mexicanos ("PEMEX") and the Federal Electricity Commission (Comision Federal de Electricidad or the "CFE") having monopolies in the oil and gas and electricity sectors respectively. In the past few years, however, with the advent of the North American Free Trade Agreement ("NAFTA") and the economic crisis brought on by the devaluation of the peso at the end of 1994, the Mexican Government has cautiously begun to de-regulate certain aspects of the energy sector, particularly electricity generation and more recently, the transportation, storage and distribution of natural gas.

Recognizing that its resources to finance infrastructure to meet projected increases in demand for electricity were woefully inadequate, at the end of 1992, the Mexican Government amended the federal Public Service of Electric Energy Law (the "Electric Energy Law") to allow private, including foreign, investment in electricity generation for self-supply and for exclusive sale to the CFE. New regulations to the Electric Energy Law (the "Electric Energy Regulations") were published in May, 1993 implementing the changes to the Law.

In the spring of 1995, Mexico amended its petroleum legislation to allow private companies to transport, store and distribute natural gas, reflecting the Mexican Government's policy of promoting a shift from the consumption of fuel oil to natural gas in the industrial and household sectors, as well as for the generation of electricity. Now private parties, including companies in which foreign investors have a controlling interest, may not only

1. A paper prepared for the Private Energy in Mexico Conference, organized by the Center for Business Intelligence, New York, New York, April 7-8, 1997. Mr. Angulo is a partner at Baker & McKenzie working out of the firm's Ciudad Juárez, Mexico office; Mr. Dubovoy is a partner at Baker & McKenzie working out of the firm's Chicago, Illinois office; Ms. Osmond is a partner at Baker & McKenzie working out the firm's Toronto, Canada office.

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transport, store and distribute natural gas, but also build, operate and own the related pipelines, installations and equipment. They may also freely import and export natural gas. To implement these amendments, on November 8, 1995, Mexico issued new Natural Gas Regulations (the "Natural Gas Regulations").

The opening up of the electricity generation and natural gas sectors is expected to attract substantial private investment, both foreign and domestic. This paper will provide an overview of these important legislative and regulatory changes affecting the electric energy sector and the distribution of natural gas, and concludes with a discussion of the legal framework for foreign investment in the country.

II. Background.

A. The Constitution.

Article 27 of the Mexican Constitution expressly reserves to the state, the ownership of petroleum and other hydrocarbon resources, as well as the generation, transmission, transformation, distribution and supply of electric energy as a public service. Article 27 further states that no concessions to private companies may be granted in these areas. Article 25 of the Constitution also provides that the public sector is exclusively responsible for strategic areas identified in Article 28 of the Constitution and must maintain ownership and control of entities established in such areas. Among others, Article 28 names petroleum and other hydrocarbons, basic petrochemicals and electricity as strategic areas. These provisions of the Constitution are reflected in the laws relating to the petroleum and electric energy sectors, as well as in foreign investment laws.

B. The Players.

Because of the predominant role that the state plays in the energy sector in Mexico, it is important to know the key players from the public sector.

1. PEMEX.

PEMEX is probably the best known of all state-owned enterprises in Mexico. PEMEX was created in June 1938 to take over petroleum assets expropriated from foreign owned companies. After the Mexican revolution of 1910, the Mexican Government had serious concerns that its economic dependence was being imperiled by the control that foreign entities had over its oil and gas sector. Article 27 of the Mexican Constitution of 1917 specifically reserved ownership of valuable minerals, including petroleum, to the state. This constitutional principle was implemented in the Petroleum Law of 1925. Among other things, the law required special government confirmation of oil production rights granted prior to 1917. Attempts to enforce the law predictably escalated tensions between foreign oil companies and the Mexican Government. Relations with oil companies deteriorated still further in the mid-1930's as a result of increasing unrest among Mexican petroleum workers. Mexican President Lazaro Cardenas issued an expropriation decree on March 18, 1938, which eliminated foreign ownership and gave the state exclusive control over Mexican petroleum resources. In addition to transferring the expropriated assets to PEMEX, the Mexican Government dissolved all government agencies involved with the
petroleum industry and assigned their functions to PEMEX. As a result, PEMEX gained broad control over exploration, development, refining, transportation, storage, distribution, and first hand sales of oil, natural gas and related products.

PEMEX was formed as a decentralized government agency owned jointly by the federal government and the petroleum workers union. In theory, PEMEX enjoyed autonomy from government control and the ability to conduct commercial activities like any private enterprise. In practice, PEMEX was subject to a number of political and economic constraints that distinguished it from most private enterprises. Management of PEMEX was vested in an 11-member board with six of its board members appointed by the President of Mexico and the remainder by the petroleum workers union. Because of the close inter-relationships between PEMEX management and government officials, PEMEX decisions were often guided by political considerations. These factors led to a series of policies which over the years have diminished the capital available to PEMEX for reinvestment.

Due to rising world oil prices during the 1970's and the discovery of new oil reserves in southern Mexico, the potentially destructive effects of these policies largely went unrealized during those years. But the depletion of profits and the lack of reinvestment by PEMEX in its own infrastructure from 1982 onwards have led to a predictable decline in production and revenues. Mexico did not replace its oil and gas reserves for most of the 1980's. By the end of the decade, its failure to accumulate internal funds because of high taxes and social obligations, placed PEMEX in dire need of investment for oil and gas exploration and production. Lack of reinvestment also increased environmental and safety hazards. A climax was reached when a leaky PEMEX pipeline caused an explosion in Guadalajara in April 1992, killing over 200 people.

PEMEX began a long term restructuring program shortly after the election of President Carlos Salinas de Gortari in 1988. The number of PEMEX employees was cut in half. President Salinas took a number of other steps to place economic pressure on PEMEX, opening Mexico to petrochemical imports and bringing in a small number of foreign contractors. In the aftermath of the Guadalajara tragedy, further steps were taken to restructure PEMEX. President Salinas seized the opportunity to dismiss several PEMEX directors and to divide the company into its constituent parts. PEMEX was converted to a new holding company, Petroleos Mexicanos Corporativo, which remains responsible for overall strategic planning and finance, and four subsidiaries: PEMEX Exploration and Production, PEMEX Refining, PEMEX Gas and Basic Petrochemicals, and PEMEX Secondary Petrochemicals. As a consequence, the new petroleum exploration and production subsidiary is no longer able to use the profits of other PEMEX operations to finance its losses.

2. **Federal Electricity Commission.**

The equivalent of PEMEX in the electricity sector is the CFE. The CFE is a state-owned entity created by the Mexican Federal Government in 1937, responsible for the generation, transmission and distribution of electric energy. It was not until the 1960's under President Lopez Mateos, however, that private entities operating in the electricity sector
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were nationalized. The CFE currently operates some 168 generating plants with an installed capacity of just over 33,000 MW, generating approximately 90 percent of the electrical energy consumed in Mexico.

3. **The Ministry of Energy.**

The Ministry of Energy is the federal ministry responsible for managing the country's energy policy, exercising the constitutional rights of the state in the petroleum, electrical and nuclear sectors and managing the activities of state-owned enterprises in the sector, such as PEMEX and the CFE. The Ministry of Energy is also responsible for promoting private sector participation in those areas in which the private sector is permitted to invest, such as generation of electricity. It must also carry out medium and long term planning and establish economic and social directives for the state-owned enterprises in the energy sector. It also issues permits and authorizations in energy matters in accordance with the applicable legislation and is responsible for ensuring strict compliance with environmental legislation and standards in the sector, realizing and promoting studies in areas of interest to the energy sector, such as energy conservation and tariffs and prices, and preparing and issuing Mexican official standards or "NOMs" in its area of competence.

4. **Energy Regulatory Commission.**

The Energy Regulatory Commission (Comision Regulatoria de Energia or "CRE") was created at the beginning of 1994 through a decree published in the Federal Official Gazette on October 4, 1993. It is a decentralized technical body within the Ministry of Energy responsible for resolving questions relating to the application and interpretation of regulatory provisions deriving from Article 27 of the Constitution with respect to electric energy. Among other powers, the Commission has full authority to render its opinion regarding the issuance of permits under the Electric Energy Law; to participate in the carrying out of studies for purposes of establishing prices and tariffs for products and services related to electric energy; to supervise the performance of contracts for the purchase of additional capacity and electric energy between the CFE and permit holders; to function as conciliator in controversies between permit holders or between permit holders and the CFE, and as appropriate to issue arbitration awards in accordance with applicable legislation; and to propose NOMs in the electricity sector.

On October 31, 1995 a new *Energy Regulatory Commission Law* was published in the Federal Official Gazette giving the CRE additional responsibilities in the area of natural gas. In particular, the CRE was given responsibility for approving the terms and conditions for first hand sales of natural gas and issuing directives for the determination of prices in situations where effective competition does not exist; approving the terms and conditions for the rendering of transportation, storage and distribution services in respect of natural gas and issuing directives for determining the consideration to be paid for such services where effective competition does not exist; and issuing and revoking permits in the natural gas sector.

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C. NAFTA AND THE ENERGY SECTOR.

While the negotiation of NAFTA had raised expectations among U.S. and Canadian companies that the Mexican energy sector might at last be opened up to foreign participation, ultimately U.S. and Canadian negotiators accepted that given the historical and political significance of this sector in Mexico, it was essentially an area that was not open to negotiation. Under NAFTA, Mexico reserved exclusive control over a wide range of activities in the energy sector, including the exploration and exploitation of crude oil and natural gas; refining and processing of crude oil and natural gas; foreign trade, transportation, storage and distribution, up to and including first hand sales, of crude oil and natural gas; and the supply of electricity as a public service, including the generation, transmission, transformation and distribution of electricity.

NAFTA does allow U.S. and Canadian suppliers of natural gas to negotiate supply contracts directly with Mexican end-users, although it was provided that such contracts could be subject to regulatory approval. Moreover, although Mexico would not agree to open up its upstream sector directly, it did agree to permit state enterprises to negotiate performance contracts in their service contracts. Under this provision, PEMEX could, for example, include a bonus clause in an exploration and production service contract, in the event hydrocarbons were discovered and produced at a predetermined flow rate for a prescribed period of time.

Finally, Mexico agreed to open up investment in electricity generation facilities to U.S. and Canadian investors. Specifically NAFTA provides that U.S. or Canadian enterprises may acquire, establish, or operate electric generating facilities for self-supply and co-generation energy production, provided electricity generated in excess of the company's own supply requirements is sold to the CFE. In addition, the acquisition, establishment or operation of electricity generating facilities for independent energy production in Mexico by U.S. and Canadian enterprises is contemplated, provided all the electricity generated by such facilities is sold to the CFE under terms and conditions mutually agreed by the parties.

D. MEXICAN GOVERNMENT'S FUEL POLICY.

Mexico has the eighth largest oil reserves in the world and is also the sixth largest producer of natural gas. Traditionally, however, Mexico has focussed on exploration and exploitation of oil, with most of the natural gas produced being associated gas. As a result, Mexico has not developed the infrastructure necessary to exploit its natural gas reserves which remain seriously underdeveloped. Moreover, much of the natural gas which is produced comes from the Campeche-Reforma fields in southern Mexico far from the industrial centers in northern Mexico.

The development of Mexico's oil and gas reserves has had implications for fuel supply for electricity generation in the country. In 1994, approximately 55.5 percent of electric energy was generated with fuel oil, compared with 12.6 percent with natural gas.3

3. Dr. Jose Luis Aburto Avila, Antecedentes, Situation Actual y Perspectivas de los Combustibles para Generacion Electrica, a paper presented at the Mexico Power Conference and Exhibition, Monterrey, Mexico, October 8-10,1996.
In 1993, the Mexican Department of Energy established the Fuel Policy Group (Grupo de Política de Combustibles or "GPC") comprised of representatives of the principal government departments and entities with an interest in the energy sector, including in addition to the Energy Department, the Department of Finance and Public Credit ("Hacienda"), the Department of the Environment, Natural Resources and Fisheries ("SEMARNAP"), the Department of Commerce and Industrial Development ("SECOFI"), PEMEX-Refining, PEMEX-Gas and Basic Petrochemicals and the CFE. The GPC was charged with the goal of developing a long term integrated fuel policy strategy for Mexico. The principal conclusions of the GPC included that the consumption of fuel oil had to be reduced in favor of natural gas and that a series of priority investments had to be realized in the petroleum refining, natural gas and electricity generation sectors. The strategy developed by the GPC consists of three phases:

4. the establishment of the natural gas regulations.
4. technological advances in electricity generation, with a greater participation of combined cycle units that use gas.
4. the existence of an ample dual (gas-fuel oil) electric generation capacity and the low cost of burners for the use of gas in areas with access to gas supply.
4. the penetration of natural gas in residential and commercial markets, through urban distribution networks.

This change in the structure of demand of both fuels imply challenges of great magnitude for PEMEX. It is necessary to take actions to attain the notable increase in the consumption of natural gas and to dispose in an economic manner of the excesses of fuel oil which it generates in the north of the country. The business plans of subsidiaries of PEMEX take into account this discontinuity in demand. [Translation]

III. Amendments to the Electric Energy Law.

A. GENERAL.

In anticipation of NAFTA, the Mexican Government published amendments to the Electric Energy Law in the Federal Official Gazette on December 23, 1992 and new Electric Energy Regulations on May 31, 1993, which liberalize the country's electric energy sector, to allow both private Mexican and foreign firms to generate energy for private consumption and for sale to the CFE, as well as to import (for self-consumption) and export electricity. Previously, only self-supply projects were allowed in Mexico and third-party generation was prohibited. The amendments to the Electric Energy Law and the Electric Energy Regulations therefore expand the role that private developers may play in meeting the nation's rapidly expanding electric energy requirements.

Under the amended provisions of Electric Energy Law, the provision of electricity as a "public service" continues to be reserved to the state through the CFE. The following activities are considered to constitute the provision of electricity as a "public service":

(i) the planning of the national electric system;
(ii) the generation, transmission, transformation, distribution and sale of electricity; and
(iii) the performance of all works and installations required for the planning, execution, operation and maintenance of the national electric system.

In addition to providing electricity as a public service, the CFE may also export electricity and has the exclusive right to import electricity for public service supply.

The activities which are considered not to constitute public services and which therefore may be carried on by private entities were significantly broadened by the amendments. The activities deemed not to constitute "public service" are:

(i) generation of electricity for self-supply, co generation or small production;
(ii) generation of electricity by independent producers to be sold to the CFE;
(iii) generation of electricity derived from co generation, independent production and small production for export;
(iv) importation of electricity by individuals or companies exclusively to meet their own needs; and
(v) generation of electricity for emergencies caused by interruptions of public service.

Except generation of electricity in the event of emergencies, all of the foregoing activities require a permit from the Ministry of Energy. Each of these types of permits is discussed in the following section.

B. TYPES OF PERMITS.

1. Self-supply.

Self-supply of electricity is defined as the use of electricity for purposes of self-consumption when:

(i) the electricity originates from generation facilities intended to meet the needs of all the co-owners or partners; and
(ii) the permit holder expressly agrees to utilize the electricity within the areas authorized by the Ministry of Energy.

Generally, self-supply is limited to supplying original project owners; electricity may not be sold to third parties. However, in certain circumstances new users may be included, provided the prior authorization of the Ministry of Energy is obtained. Surplus energy must be placed at the disposition of the CFE.

2. Co-generation.

Co-generation is defined as:

(i) the production of electric energy together with steam or other types of secondary thermic energy, or both;
(ii) Direct or indirect production of electric energy from thermic energy not utilized in the particular processes in question; and
(iii) direct or indirect production of electric energy out of fuel produced in the processes in question.
Any party interested in obtaining a permit for co-generation of electricity must meet the following conditions:

- The electricity generated must be destined to satisfying the needs of establishments associated with the co-generation, understood as being the individuals or commercial entities that carry out the processes which are the basis for the co-generation, or which are co-owners of the installations or shareholders of the company in question, provided they use the electricity, or it is placed at their disposition, or they collaborate in the process which produces or make its use possible; and

- The permit holder agrees to make the excess electricity available to the CFE.

Co-generation permits may be issued to persons distinct from the operators of the processes giving rise to the co-generation. In such case, the application must also be signed by the operators and accompanied by a certified copy of the incorporation instrument of the company established for purposes of carrying out the project. The operators assume joint responsibility with the permit holder with respect to its obligations under the Electric Energy Law and Regulations.

3. **Independent Production.**

Independent production is defined as the generation of electricity by a plant with a capacity greater than 30 MW, intended exclusively for sale to the CFE or for export. Applicants for permits for independent production must be Mexican citizens or companies organized under Mexican law with their domicile in Mexico. This provision does not prevent investment by foreign companies who are simply required to incorporate a Mexican subsidiary. In the case of energy destined exclusively to the CFE, the project must be included in advance in the plan and in the program of the CFE, or be equivalent to a project so included. The applicants must commit themselves to sell the electrical energy produced exclusively to the CFE under long term contracts in accordance with the terms of the Electric Energy Law, or to export all or a portion of such production with the permission of the Ministry of Energy.

4. **Small Production.**

Small production is defined as the generation of electricity intended for:

(i) sale in full to the CFE, in which case the projects may not have a total capacity greater than 30 MW, in an area determined by the Ministry of Energy;

(ii) self-supply for small rural communities or isolated areas which do not have electric energy service, in which case the projects may not exceed 1 MW and the interested parties must create consumption cooperatives, co-ownerships, civil associations or companies, or enter into joint cooperation agreements for such purpose; and

(iii) export, within the maximum limit of 30 MW.

Applicants must be Mexican individuals or companies organized under Mexican law with their domicile in Mexico. In the case of permits requested for purposes of the activities referred to in (i) and (iii) above, the permit holder may not be the owner within the same area of small production projects with a total capacity exceeding 30 MW. No permits are required for projects for self-supply of electricity below 0.5 MW.
5. **Exports.**

Export of electricity generated out of co-generation, independent production and small production projects may be permitted subject to compliance with applicable laws and regulations. The applicant must enclose with its application the electricity purchase agreement or the corresponding letter of intent. The permit holder must not sell the electricity generated for export within Mexico, unless a special permit is granted by the Ministry of Energy. In evaluating applications for export permits, the Ministry of Energy must consider the requirements for electric energy within the national territory in the relevant zone, as well as the type of fuel to be used.

6. **Imports.**

Permits may be granted by the Ministry of Energy to acquire electricity from generating facilities located abroad through contracts entered into directly between the supplier of the energy and the consumer. The import permit must establish, with the CFE's advice, the terms and conditions under which the permit holder will request supply from the CFE, in the event that the importation is cancelled. The importation of the electricity is subject to the payment of import duties established by the applicable law. Except where they are connected to the national grid, applicants for import permits must commit themselves to operate their respective installations in the country through their own means and personnel and to comply with the applicable legal and regulatory provisions, as well as NOMs.

C. **Rights to Transmit, Transform and Distribute.**

The right to generate energy under any of the permits discussed above may include rights to transmit, transform and distribute the energy generated depending on the circumstances of each case. Permit holders may construct the transmission lines which they require, provided that such lines do not connect with the public service grid and complies with the applicable NOMs. Temporary grid access may also be obtained from the CFE by means of a contract and for consideration which is economic, when such use will not place energy service at risk or affect the rights of third parties. When the existing installations do not permit the CFE to render the transmission services, the CFE may contract with the applicant for the construction of the necessary installations. Grid access does not, however, imply that licensees have the right to sell, resell or transfer electric energy capacity to entities other than the CFE.

D. **Issuance of Permits.**

All permits are effective for an indefinite period, with the exception of permits for independent production which are for a duration of thirty (30) years. Permits for independent production can be renewed, provided applicable regulations are satisfied. In order to generate electricity under conditions distinct from those of the permit, prior authorization must be requested from the Ministry of Energy. A change in the destination of the electric energy generated requires the issuance of a new permit. Permits may also be transferred when the installations covered by the permit are sold, provided the prior authorization of the Ministry of Energy is obtained.

The Regulations set out the information to be provided in the application and the documents to be attached. Where ownership of a generating plant belongs to various per-
sons, the permit will be issued to all the interested parties, provided a common representa-
tive is designated to act before the Ministry of Energy, with sufficient authority to act in
their name and to assume joint responsibility for compliance with the Electric Energy Law
and Regulations.

The Ministry of Energy must examine applications within ten (10) business days. If
accepted for consideration, the application must then be referred to the CRE for its opin-
ion. The CRE must provide its response within thirty (30) days, ten (10) days in the case
of an application for a small production permit. The Ministry of Energy is not bound,
however, by the opinion of the CRE. When the opinion of the CRE may imply modifica-
tions to or restrictions on the plans set forth in the application, the applicant must be noti-
fi ed so that it may respond within a period of ten (10) business days. The Ministry of
Energy may also, with the knowledge of the applicant, solicit additional clarification and
facts, as well as technical memoranda. Once such information is received, the Ministry of
Energy has thirty (30) business days to decide whether to issue the permit.

Permit holders are obligated to:

- not sell, resell or alienate by any means, direct or indirect, capacity or electric ener-
gy, except in those situations authorized by the Electric Energy Law and the
Regulations;
- notify the Ministry of Energy of the date on which the works have been concluded,
within fifteen (15) business days of their termination;
- provide to the extent possible and for the corresponding payment, electric energy
required for public service, when by act of God or *force majeure* such service is
interrupted or restricted, but only for the period of the interruption or restriction;
- comply with the legal and regulatory provisions, as well as the NOMs and other
provisions applicable to the works and installations which are covered by the per-
mit;
- operate and maintain their installations and equipment in a manner such that they
do not constitute a danger for the permit holder or third parties; and
- once the operation of the installations is begun and exclusively for statistical pur-
poses, inform the Ministry of Energy in prescribed form of the type and volume of
fuel used and the quantity of electric energy generated, specifying the portion used
to satisfy their own needs and that delivered to the CFE or destined for export, as
well as where applicable, importations of electric energy realized.

During the past three years some 47 permits have already been issued to private sector
entities for the various types of generation permitted under the Law representing a capaci-
ty of 1894 MW, and one import permit for 4 MW.5

E. INCREASE AND SUBSTITUTION OF CAPACITY BY THE CFE.

Under the Electric Energy Regulations, the CFE is required at least once a year to
deliver to the Ministry of Energy, a Prospective Document (*Documento de Perspectiva*)
covering the trends in the electrical sector of the country and programs required to realize
the works that the CFE intends to carry out in order to render its services. Based on this
Prospective Document, the Ministry of Energy then determines periodically, the increase

or substitution of capacity required in order to satisfy the electrical energy demand of the country and whether the necessary projects should be carried out by the CFE or whether the generation capacity required should be obtained from private entities through a request for tenders.

F. CALLS FOR TENDERS.

Under the Electric Energy Regulations, for all acquisitions of capacity in excess of 20 MW, a call for tenders must be issued.\(^6\) Holders of small production, independent production, co-generation and self-supply permits may respond to such calls for tenders. Holders of small production and independent production permits must offer to place at the disposal of the CFE all of their generation capacity, whereas holders of co-generation and self-supply permits offer their excess capacity.

The call for tenders must be set forth in such a form as to allow interested parties flexibility in setting out their proposals with respect to technology, fuel, design, engineering, construction and location of the installations. Notwithstanding the foregoing, the Ministry of Energy may when it considers it necessary, instruct the CFE in writing to include precise specifications in the call for tenders with respect to the type of fuel to be used for the generation of the electricity. The CFE may also indicate the preferred point of interconnection, or as appropriate, the alternative points of interconnection and the cost to the CFE of transmission and the maximum capacity that can be accepted. The bases for the call for tenders must contain the methodology for the filing of proposals as well as the criteria to be used for purposes of evaluating the proposals. Persons participating in a call for tenders which do not hold the appropriate generation permits, must include with their proposals, documents demonstrating that they satisfy the requirements to be permit holders.

The CFE must evaluate proposals under the strict supervision of the Ministry of Energy, to determine which of the solutions is the most suitable in terms of technical viability, total cost in the long term of the electric energy, stability, quality and security, justifying and explaining its decision. The project will be awarded, as appropriate, to those who individually or jointly, fulfill the conditions established in the call for tenders and individually or jointly offer the capacity required in such a way that it is obtained at the lowest cost to the CFE, considering the total cost in the long term of the electric energy in the various proposals and where applicable, the cost to the CFE of transmission.

The CFE must issue its decision within the time frame indicated in the call for tenders. Once the project has been awarded, the CFE will enter into a contract with the successful bidders. The minimum terms and conditions which must be contained in such contracts are set out in the Electric Energy Regulations. The Regulations also deal with the determination of the consideration to be paid for the electricity. In general terms, the consideration will be fixed based on a payment for capacity, adjusted for an availability factor, and a payment for the electricity delivered to the point of interconnection. Payments for capacity and energy must reflect, respectively, the fixed costs, including a return on investment, and the variable costs incurred by the permit holder. The payment for capacity will be adjusted each month applying a coefficient calculated based on an availability factor as

\(^6\) Generation capacity of 20 MW or less may be acquired through a written contract between the CFE and the permit holder without the need to issue a call for tenders.
set out in the Regulations. The parties to the contract may also include actualization formulas in respect of the payments to be made by the CFE, to take into account factors such as the price of fuel.

G. FOREIGN INVESTMENT.

Under the Foreign Investment Law (the "FIL"), published in the Federal Official Gazette on December 27; 1993, activities in strategic areas, such as electricity, are reserved exclusively to the Mexican state, but only to the extent they are specifically referred to in the applicable legislation. Therefore, in the case of electricity, in general it is only in those activities specifically identified in the Electric Energy Law and the Regulations as being reserved to the state (through the CFE) in which foreign investment is restricted.

IV. New Natural Gas Regulations.

A. GENERAL.

On May 11, 1995, Mexico published in the Federal Official Gazette, amendments to the Regulatory Law of Article 27 of the Constitution in Petroleum Matters (the "Regulatory Law") to allow private companies to transport, store and distribute natural gas. The amendments removed these activities (other than transportation and storage which is indispensable and necessary to interconnect the exploration and exploitation of natural gas) from the definition of "oil industry", which is otherwise reserved to PEMEX. Now private parties, including companies in which foreign investors have a controlling interest, may not only transport, store and distribute natural gas, but also build, operate and own the related pipelines, installations and equipment. They may also freely import and export natural gas. Only the exploration, extraction, and first hand sales of gas remain restricted to PEMEX.

To implement the amendments to the Regulatory Law, on November 8, 1995, Mexico published the Natural Gas Regulations. The Natural Gas Regulations govern, among other things, (i) the importation and exportation of natural gas; (ii) first hand sales of natural gas and the services to be provided by PEMEX to private parties who request them; (iii) the permits for the transportation, storage and distribution of natural gas and self-use permits; (iv) the terms and conditions for the provision of the services of transportation, storage and distribution of natural gas, including the services that must be provided to other parties engaged in similar activities; and (v) the procedures for setting tariffs and prices. The following discussion covers selected provisions of the amendments to the Regulatory Law and the Natural Gas Regulations of particular interest to private investors.

B. IMPORT AND EXPORT OF NATURAL GAS.

Natural gas may now be freely imported and exported by any private party under the terms of the Foreign Trade Law. Importers and exporters will have certain reporting obligations to the CRE in connection with their imports and exports but otherwise such activities will be unrestricted, subject to compliance with customs requirements. Therefore, companies located in Mexico will now have free access to imported gas to satisfy their fuel requirements.
C. First Hand Sales and Services Provided by PEMEX.

PEMEX continues to have the exclusive right to make first hand sales of natural gas. The Natural Gas Regulations define "first hand sales" as the first transfer of natural gas of Mexican origin made by PEMEX to a third party for delivery in Mexico. The terms and conditions for first hand sales of natural gas, including the purchase price, may be agreed upon freely by the parties, except if effective competition conditions do not exist. In the absence of free competition, the maximum price will be determined in accordance with directives of the CRE (discussed below); any other terms and conditions will be subject to the CRE's approval and will have to be consistent with both national and international commercial practices of companies engaged in the purchase and sale of natural gas.

PEMEX must offer to first hand purchasers of natural gas at least two types of quotations for the volumes that they need. One price will quote delivery at the processing plant, and the other at the point or points designated by the purchaser. In order to protect companies acquiring natural gas from PEMEX, the Natural Gas Regulations expressly prohibit PEMEX from unduly discriminating among natural gas purchasers.

To assist parties interested in participating in the opening up of the natural gas sector, PEMEX must provide transportation services to those who request the service. PEMEX must respond to such requests within one month and may only deny the service if it does not have available capacity or due to technical impediments. In accordance with the requirement that PEMEX establish and begin operation of the information systems and mechanisms and equipment required to provide third parties access to PEMEX's transportation systems by November 9, 1997, PEMEX submitted an Open Access Program to the CRE. The Open Access Program was approved pursuant to a resolution of the CRE published in the Federal Official Gazette on August 7, 1996.

D. Permits.

1. General.

The transportation, storage and distribution of natural gas requires a prior permit from the CRE. Interested parties may obtain permits for one or more of these activities. Parties interested in obtaining a permit must notify the Federal Competition Commission (the "Competition Commission") of their intention to engage in the above activities. In order that the Competition Commission may verify compliance with Mexican anti trust law, the interested parties must file with the Competition Commission a copy of their permit application or of their bid, in the case of a public bidding process.

Permits have a duration of thirty years, and may be renewed indefinitely for fifteen year terms. They must contain the terms for providing the services, including the applicable tariffs. They may also include provision for arbitral proceedings for the resolution of disputes, if proposed by the permit holder in its application. Generally, permit holders must initiate the required works to provide the services covered by their permits within six months from the issuance of their permits. Each of the various types of permits is discussed below.
2. **Transportation Permits.**

"Transportation" is defined in the Natural Gas Regulations as the activity of receiving, carrying and delivering natural gas through pipelines to persons who are not end-users located within a specific geographic area. "Transportation service" is considered to comprise the receipt of natural gas at one point of the transportation system, and the delivery of a similar amount at a different point in the system. Transportation permits are non-exclusive. The CRE will issue such permits for a specific capacity and route (trayecto) either (i) upon application of the interested parties; or (ii) pursuant to a bidding process called by the CRE upon request of the federal or state governments. Transportation and distribution permits generally may not be granted to the same entity, either directly or indirectly, to serve the same geographic area. Also, companies with transportation permits must include in their charter/by-laws the obligation to maintain a minimum capital equivalent to ten percent of the proposed investment.

3. **Storage Permits.**

"Storage" is defined as the activity of receiving, keeping in deposit and delivering gas, when the gas is maintained in deposit in fixed installations distinct from pipelines. "Storage service" is comprised of the receipt of natural gas at one point in the storage system, and the delivery, in one or several acts, of a similar amount at the same point, or another contiguous point of the same system. Like transportation permits, storage permits will also be non-exclusive. The CRE will issue them for a specific capacity and location upon application of the interested parties (not through bidding processes).

4. **Distribution Permits.**

Distribution is the activity of receiving, carrying, delivering and if applicable, marketing of natural gas, through pipelines within a specific geographic area. "Distribution service" comprises (i) the marketing and delivery of natural gas by the distributor to an end-user within its geographic area, or (ii) the receipt of natural gas at the reception point or points in the distribution system, and the delivery of a similar amount at a different point in that system. The CRE will issue distribution permits for specific geographic areas that it will determine, considering the factors required for the profitable and efficient development of the distribution system and the urban development plans affecting each area. Generally, a geographic area will correspond to a population center. The first distribution permit for a specific geographic area must be granted pursuant to a public bidding process and afford a twelve-year exclusivity right to construct the distribution system and to receive, carry and deliver natural gas. It will not, however, grant exclusivity for the marketing of the natural gas. Subsequent distribution permits will be granted upon request of the interested parties (not through bidding processes) and will be non-exclusive. The geographic area may be modified in accordance with the directives to be issued by the CRE, but if the modification occurs during the exclusivity period, the permit holder's consent will be required. Companies with distribution permits must also include in their charter/by laws the obligation to maintain a minimum capital equivalent to ten percent of the proposed investment.

Users, who may or may not be end-users, located within a geographic area may contract the supply of natural gas from suppliers other than the distributor. The Regulations define "user" as a person that uses or requests the services of a permit holder, and "end-
user” as the person that acquires natural gas for its own consumption. In this case, the distributor must allow the users to have open and non discriminatory access to its system in exchange for payment of the corresponding tariff. This access will be limited to the idle capacity of the distributor.

5. Self-Use Permits.

When the applicant plans to receive, store, carry and deliver natural gas exclusively for the applicant's own needs (or the needs of the applicant’s partners or shareholders, in the case of a "self-supply company"), the CRE may grant it a special transportation and/or storage permit for self-use. To receive a self-use permit during the first two years of the exclusivity period of a distribution permit, the applicant (or its partners or shareholders, in the case of a self-supply company) must have an annual average consumption greater than 60,000 cubic meters per day. If the applicant files the application during the third or fourth year of the exclusivity period, the annual average consumption must be greater than 30,000 cubic meters per day. No minimum consumption will be required from the fifth year of the exclusivity period. A user of the distribution service who is interested in obtaining a self-use transportation permit must notify the distributor three months prior to filing its application. Holders of transportation or distribution permits may not hold a storage permit for self-use.


Applications for permits, other than self-use permits, must include (i) a description of the project; (ii) a description of the safety methods and procedures for operating and maintaining the system; (iii) documentation that proves the technical viability of the project; (iv) documentation that proves the technical, administrative and financial capacity of the applicant; (v) investment programs and minimum commitments, as well as the stages and timetable to carry them out; (vi) the proposed terms and tariffs for the provision of the service(s); (vii) copy of the notice to the Competition Commission; (viii) a description of the conditions of operation, the computer systems and the mechanisms and equipment that will be used to provide open access to third parties; (ix) justification of the potential demand;7 (x) the sources of natural gas supply;8 and (xi) the policies to provide distribution services to new end users within the relevant geographic area, including those cases in which those end-users will pay connection charges.

The CRE must examine applications for permits within one month. If any elements are missing, it will inform the applicant and the applicant will have another month to complete the application. Once the application satisfies all requirements, the CRE will begin its evaluation of the application, publish a summary of the proposed project in the Federal Official Gazette, and open a two-month period to receive other applications, objections or comments in connection with the project. If as a result of the publication in the Federal Official Gazette other persons file applications, the CRE will issue permits to all that meet the requirements.

7. In the case of transportation permits.
8. In the case of transportation and distribution permits.
The CRE must conclude its evaluation within three months from the date it starts the evaluation process. As a result of its evaluation, the CRE may require applicants to modify a project, and if so, it must grant them a term not to exceed three months to modify their application accordingly. Within one month of concluding the evaluation, the CRE will issue the permit if all requirements are met by the applicant and the project is approved.

With the CRE's prior approval, permit holders may transfer their permits, together with the corresponding systems, when the potential transferees meet the requirements to be permit holders and undertake to comply with the obligations associated with the permits.

With the prior approval of the CRE, permit holders may also encumber their permits and the corresponding systems. If they encumber the permits to guarantee obligations or financing directly related to the provision of the service, they will only be required to give notice to the CRE ten (10) days in advance.


The CRE may initiate a public bidding process (i) whenever it considers that there are enough factors to justify the carrying out of a distribution project and, as appropriate, determine a geographic area; or (ii) when transportation projects promoted by the Federal Government or the governments of the states are involved. Interested parties may also request a public bidding process by filing with the CRE a "declaration of interest". The CRE will evaluate and respond to the "declarations of interest", determining whether it will initiate the bidding process, within two (2) months.

To initiate the bidding process, the CRE must publish a call for tenders which must contain at a minimum (i) the object of bidding process and the route or geographic zone involved; (ii) the terms, place and time during which the bases or terms and conditions for the bidding process will be available to interested parties; and (iii) the cost and form of payment for the bases for the bidding process.

The bases for the bidding process must indicate at a minimum:

(i) the object, description and technical specifications of the project, which must be such as to permit interested parties the greatest flexibility to express the content of their bids, with respect to technology, design, engineering, construction and location, in relation to the route or geographic zone involved;

(ii) the necessary documentation and the terms for delivering it;

(iii) the requirements with respect to the presentation of:

• the generic description of the security methods and procedures for the operation and maintenance of the systems;

• the list of permits, authorizations and other administrative acts necessary to carry out the works relating to the project, as well as the anticipated program to obtain them;

• the notice to the Federal Competition Commission of the intention to obtain a permit;

• the programs and minimum commitments for investment in order to render the service;

• the type of insurance and coverage required; and

• proposal containing the general conditions for rendering the service;

(iv) the manner to evidence the minimum financial, technical and administrative capacity of the applicant to render the service;
(v) the form and amount of guarantees to guarantee the seriousness of the bid;
(vi) the methodology for proposing tariffs;
(vii) the procedure for the presentation of bids;
(viii) the information that must be included in the technical and economic bids;
(ix) the criteria for awarding the permit;
(x) information with respect to the place, date and time of the clarification meetings for the bases of the bidding process;
(xi) Place, date and time for the presentation and opening of the bids;
(xii) mention that any modification to the bases for the bidding process must be published in the same medium as the original call for tenders, at least twenty (20) days prior to the original date indicated for the presentation and opening of bids;
(xiii) the causes for declaring the bid process abandoned; and
(xiv) the place, date and time of the award, as well as the manner in which it will be communicated to the participants.

At least three (3) months must elapse between publishing the call and receiving bids. Bids are evaluated in two stages, the first technical and the second economic. Only bids which meet the technical requirements are considered in the second stage. The permit must be awarded to the applicant offering the most economically advantageous bid in accordance with the bid's terms and conditions. The CRE must make its award within three (3) months of receiving the bids, and the permit must be issued within one (1) month of the award being made.

E. Regulation of Supply of Services.

The Natural Gas Regulations establish a number of terms and conditions for the supply of services relating to natural gas, including the following. Permit holders must respond to all service requests within one (1) month from receiving the request, in the case of transportation or storage services, and ten (10) days, in the case of distribution services.

In addition, subject to the availability of capacity, permit holders are required to allow interested third parties to have open access to the services in their respective systems, generally under the terms of agreements to be entered into with them. Except during the exclusivity period of a distribution permit, permit holders must also allow other permit holders to interconnect to their systems, in exchange for consideration, when there is available capacity and the interconnection is technically viable.

Distributors must expand their systems within their geographic area upon request by any interested party that is not a permit holder, provided that the service is economically viable. Holders of transportation permits must expand their systems within their geographic area upon request by any interested party, provided that (i) the service is economically viable, or (ii) the parties enter into an agreement to cover the cost of the pipelines and other installations required for the expansion.

Permit holders offering more than one type of service must distinguish each one from the others, including keeping separate accounting records for the transportation, storage, distribution and marketing of natural gas. They may not condition the provision of one service on another or on the purchase of natural gas.

Permit holders may not directly or indirectly subsidize the provision of one service through the tariffs for another or through the sale of natural gas, nor subsidize the latter through tariffs. In other words, cross-subsidization is prohibited.
F. SETTING TARIFFS AND PRICES.

The applicant's proposal of maximum tariffs for the provision of services included in its application for a permit will be the basis for the determination of the tariffs. It is expected that the CRE will approve the proposed maximum tariffs, unless there is good reason not to do so. In the absence of effective competition, the tariffs will be determined pursuant to directives issued by the CRE as discussed below.

The tariffs for each service must include all applicable charges, such as (i) the connection charge, which is the portion of the tariff based on a fixed amount for the cost of interconnection to the system, and may be paid in one or more installments, (ii) the capacity charge, which is the portion of the tariff based on the capacity reserved by the user to satisfy its maximum demand in a specific period, and (iii) the use charge, which is the portion of the tariff based on the provision of the service.

The tariffs proposed by the applicants may establish differences based on (i) the characteristics of the service, (ii) the category and location of the user, (iii) the conditions of the service, and (iv) other commercial customs generally accepted in the industry.

Permit holders periodically may adjust the tariffs in accordance with directives to be issued by the CRE. These directives must consider the effects of inflation, any changes in tax treatment and an adjustment factor that must reflect an increase in the efficiency of providing the services in favor of the users. This factor will not be applied to permit holders during the first five years of the permit. The tariffs resulting from the adjustment must be submitted to the CRE for approval. Every five years, the permit holders and the CRE will review the tariffs in accordance with directives to be issued by the CRE. As a result of this revision, the CRE will determine the new tariffs.

The price that distributors may charge to end-users will be composed of the purchase price for the natural gas and the transportation, storage and distribution tariffs. The parties may agree on a different price in accordance with directives to be issued by the CRE. Distributors may charge their end-users the variations in the purchase price for the natural gas and the transportation and storage tariffs, in accordance with the terms for the provision of the service contained in the permit.

G. INFORMATION TO BE PUBLISHED BY THE MEXICAN AUTHORITIES.

The Ministry of Energy must publish annually a prospective document on the performance of the domestic natural gas market. This document will describe and analyze the foreseeable natural gas needs of Mexico for a ten-year period, and will include: (i) the future evolution of both the national and regional demand, (ii) the existing and expected production capacity, and (iii) the existing transportation and distribution capacity, as well as the needs for expansion, rehabilitation, modernization, replacement or interconnection of capacity.

H. DIRECTIVE ON TARIFFS AND PRICES.

On March 21, 1996, the CRE published a directive in the Federal Official Gazette with respect to the determination of prices and tariffs applicable to natural gas activities. Among other things, the directive sets forth the methodology for the determination of: (i) the price for first hand sales of natural gas by PEMEX; (ii) end-user prices; (iii) transportation and distribution tariffs; (iv) storage tariffs; and (v) connection charges. The prices and tariffs are subject to caps intended to allow natural gas and service providers to obtain
a reasonable return, while protecting users from excessive charges. Upon request, the CRE may authorize monthly or quarterly increases in the caps when it considers it appropriate to reflect high inflation rates or material changes in the exchange rate.

I. FOREIGN INVESTMENT.

The Regulatory Law does not limit the extent to which foreign investors may have an equity participation in entities applying for a permit. However, if the activities to be directly carried out by the entity involve erection, construction or installation works, under the FIL, the foreign investor(s) would need the prior authorization of the National Foreign Investment Commission ("FIC") to own more than 49 percent of the entity. This type of authorization is usually granted and will not be required at all as of January 1, 1999.

V. Regulation of Foreign Investment in Mexico.

A. GENERAL RULE.

Foreign investment in Mexico is regulated by the Foreign Investment Law or "FIL", the regulations thereto and the rulings, guidelines and resolutions that the FIC may issue, as well as other Mexican laws and regulations with specific provisions relating to foreign investment.

Compared with prior foreign investment legislation in Mexico, the FIL represents a change in focus from regulation to promotion. This shift in emphasis has taken place not only in the legislation, but also in the attitude adopted by government officials which is much more open and positive toward foreign investment. There are, however, various limitations on foreign investment in specific areas or fields of activity. As discussed above, this is particularly the case in the energy sector.

The FIL contains a general statement that foreign investment may freely enter Mexico without any prior permission or restriction. Consequently, as a general rule foreign investors may participate in the capital of corporations and acquire fixed assets without any controls or restrictions.

The FIL eliminates previously existing restrictions on investment in new fields of activity, new product lines, and on the opening and operation of new establishments, all of which can now be carried out by foreign investors without limitation. Thus, foreign investors may freely expand their operations and adjust to changing circumstances without first having to obtain permission or enter into additional commitments with government authorities. Formerly, foreign investment was subject to various requirements and commitments relating to foreign currency balances, the form of capital contributions, employment generation and so on.

Notwithstanding this general rule, however, investment in certain areas of activity is specifically reserved to the Mexican state or to Mexican nationals, while in other areas, the level of foreign investment is restricted. These restrictions are discussed below.
B. RESTRICTIONS.

As indicated above, as a general rule foreign investment can freely enter Mexico without any prior permission or restriction, except in those specifically restricted areas of activity. In general, the FIL lists certain economic activities that are: (i) reserved to the Mexican state, (ii) reserved to Mexican nationals or Mexican companies without foreign equity participation, (iii) subject to quantitative foreign investment limitations, and (iv) subject to prior approval if the foreign investor wishes to own more than 49 percent of a company engaged in those activities. Pursuant to the FIL, restricted activities are divided into eight categories, as discussed below. Investment by "permanent residents" is not equated to Mexican investment in areas reserved to the state. Consequently, permanent resident status is not meaningful for purposes of making investments in restricted activities.

1. Areas reserved exclusively to the state.

As discussed above, investment in certain strategic areas is reserved exclusively to the state. Not all activities within a particular area are covered by this limitation, however, but only those specific functions restricted to the government under applicable legislation. Additional fields of activity may become subject to this reservation under a catch-all provision covering any other areas deemed by applicable legislation to be a strategic area.

Strategic areas reserved exclusively to the state include oil and other hydrocarbons, basic petrochemicals, electricity, generation of nuclear energy and any other activities that are expressly required to be reserved to the state in the applicable legislative provisions.

The approach adopted by the government toward such strategic areas has, however, in certain cases, been a liberal one. For example, as discussed, multiple power-related activities have been opened to foreign investment.

2. Areas reserved exclusively to Mexican individuals or Mexican companies.

Areas which are reserved exclusively to Mexican individuals or Mexican companies without any foreign equity participation include retail trade in gasoline and liquefied petroleum gas. It should be noted that indirect participation by foreign investment is not allowed. This includes any device or structure under which control or participation is obtained by foreign investors. Specifically it prevents the use of trusts, agreements, understandings and other structures which although qualifying for the investment under strict legal interpretation, do not reflect the actual transaction. In certain instances, to circumvent these restrictions, Mexican individuals may appear as shareholders of a specific corporation but a series of agreements or structures may be put in place so as to give the actual control to foreign investors. Such structures, as well as any other act that is in violation of a law may be ruled as being null and void. The FIC is not authorized to grant exemptions, not even for indirect ownership, in these categories.

3. Areas where foreign investment is restricted to specified minority percentages

In certain areas, the level of foreign investment is restricted to a minority interest with the permitted level of participation varying depending upon the area involved from 10 percent (for example, cooperative production companies) to 49 percent (for example, supply of fuel and lubricants for ships, aircraft and railroad equipment). As in the case of areas reserved to Mexicans, indirect participation by foreign investment in excess of the
permitted levels for foreign investment is not allowed in these areas. Similarly, the FIC is not allowed to grant exemptions, even for indirect ownership in these categories.

4. Areas where foreign investment is restricted, except with the FIC's prior approval.

In certain areas foreign investment is restricted to no more than 49%, but the FIC may authorize a higher, up to 100% participation, on a case by case basis. Areas which fall under this type of restriction include pipeline construction for the transportation of oil and oil derivatives and well-drilling for oil and gas.

5. Majority foreign investment in excess of a specified monetary amount.

Approval of the FIC is also required for foreign investment in Mexican companies, regardless of the activity they undertake, when the total asset value of the company in question at the time of acquisition exceeds the amount established annually by the FIC, and provided that as a result of said acquisition the direct or indirect participation of foreign investment in the capital of the companies in question exceeds 49 percent. Pursuant to a Resolution issued by the FIC and published in the Federal Official Gazette on February 19, 1997, the maximum value of the assets that may be acquired by foreign investors without prior approval is fixed at $394 million pesos, which at an exchange rate of 7.88 pesos to the U.S. dollar, is equivalent to US$50 million United States dollars, the same amount established for Canadian and U.S. investors under NAFTA. 9

6. Areas subject to temporary restrictions.

Areas subject to temporary restrictions on foreign investment include international land transportation between points located in Mexico, as well as the management of bus and truck terminals; autoparts, automotive equipment and accessories; and building and construction. Specifically in the areas of building and construction, foreign investment is limited to a minority position through December 31, 1998 (although with the FIC's prior approval foreign investment may be up to 100%). Thereafter, foreign investment may freely participate without restrictions.

7. Real estate.

In general terms, foreign investment in real estate is subject to the following restrictions:

- Foreign individuals or entities desiring to acquire real estate located within the so-called "restricted zone" (100 kms from the borders and 50 kms from the coastline), can do so through a Mexican company in which they participate, provided the purpose of the acquisition is other than residential. Such acquisitions must be registered with the Ministry of Foreign Relations. Many companies located in the "restricted zone" still have real estate trusts in place. These trusts were created in order to hold real property, as was required under past legislation. However,

9. Under NAFTA, this review threshold will be US$50 million for Canadian and U.S. investors until the end of the year 1999, at which time it will increase to US$75 million from the year 2000 through to the end of the year 2002, and thereafter will be US$150 million.
holding of real property through a trust is no longer required. Thus, under the current regulatory framework, existing trusts may be easily dissolved to avoid the involvement of another party (i.e. the trustee) and the elimination of trustee fees.

- Foreign individuals or entities desiring to acquire real property within the "restricted zone" for residential purposes must do so through a fifty year renewable trust. A prior permit is required from the Ministry of Foreign Relations. A Mexican company with foreign investment cannot own these properties.
- Foreign individuals may acquire directly real estate located outside the "restricted zone", subject to obtaining a permit from the Ministry of Foreign Affairs which is generally automatically granted. They may also do so either through a Mexican company or through a fifty year renewable trust. It is not clear whether foreign entities may also acquire directly real estate located outside the "restricted zone."

8. Restrictions imposed for reasons of national security.

The FIC is empowered to prevent foreign investments for national security reasons. There is no definition in the FIL of national security. Nonetheless, it can generally be said that anything that jeopardizes Mexican sovereignty or endangers the ability of the Mexican government to govern could be considered as a matter of national security.

Although the Mexican government has the prerogative to establish restrictions founded in national security reasons, because of the new approach and strategy towards foreign investment, this prerogative has not been exercised under any foreign investment statute. As has been explained above, the approach taken by the FIC and by other foreign investment authorities has been to a great extent a liberal one.

C. Application Procedure and Criteria.

The FIC must make a decision on applications submitted for its consideration within a period not to exceed forty-five (45) business days from the date the application is filed pursuant to the regulations of the FIL. Applications must be made in prescribed form and submitted to the FIC. The information to be supplied includes information on the applicant, information on the activity that it intends to undertake, information in connection with the acquisition of assets, location of the project, information on the parent company, location of the parent company, generation of employment, financing and other related information. If the FIC does not issue a decision within the prescribed period, the application will be deemed approved as filed and upon request of any interested party, SECOFI must issue the corresponding authorization.

In evaluating applications submitted for its consideration, the FIC must consider the following criteria:

(i) the impact on jobs and training for employees;
(ii) the technological contribution;
(iii) compliance with environmental requirements contained in the applicable environmental statutes; and
(iv) generally, the contribution toward increasing competitiveness in Mexico.

The FIC, in deciding whether an application is appropriate, may only impose requirements that do not distort international trade or violate other commitments assumed by Mexico. This provision was adopted in accordance with NAFTA. The FIC has been receptive to the projects and needs of foreign investors. As noted above, its role in many
instances has been promotional, more so than regulatory. With Mexico's need for foreign
investment, it is likely that the FIC will continue to adopt a liberal approach.

D. National Registry of Foreign Investments.

Mexican companies with foreign investment, foreign individuals or legal entities ordi-
narily carrying on commercial activities in Mexico and their branches as well as those
trusts regulated by the FIL, are required to register with the National Registry of Foreign
Investments. Such registration must be renewed annually to maintain "good standing."

E. Foreign Investment and NAFTA.

Chapter 11 of NAFTA covers investments in one NAFTA country by investors from
another NAFTA country and in the case of certain specific provisions, all investments
made in the territory of either Canada, the United States or Mexico (a "Party"). In accord-
ance with NAFTA, "investment" covers all forms of ownership and interest in a business
enterprise, tangible and intangible property and contractual investment interests. This
Chapter does not apply, however, to measures adopted or maintained by a Party to the
extent that they are covered in Chapter 14 of NAFTA, which deals with financial services.
NAFTA Chapter 11 deals with the general principles and rules applying to investments by
a investor of one Party in the territory of another Party and with the resolution of a dis-
pute between a Party and an investor of another Party.

1. General Principles.

The guiding principles of the investment provisions under NAFTA are national treat-
ment, most-favored-nation ("MFN") treatment and a minimum standard. Subject to each
Party's reservations and certain exceptions, each Party must treat investors of another
Party and their investments no less favorably than its own investors and no less favorably
than investors of other countries. At a minimum, each Party must accord to investments
of investors of another Party treatment in accordance with international law, including
fair and equitable treatment and full protection and security.

2. Performance Requirements.

No Party may impose or enforce "performance requirements" in connection with
investments in its territory, such as commitments or undertakings relating to exports,
domestic content, local sourcing, trade balancing, technology transfer or product man-
dates. This provision applies to investments from all sources, whether by investors from
another Party or a non Party and is intended to avoid distortions in trade flows among the
three countries. For those commitments previously made, an express waiver is required.
Otherwise the commitments made will have to be honored. In addition, no Party may
condition the receipt of an advantage, such as a subsidy, in connection with an investment
in its territory on compliance with requirements relating to domestic content, local sourc-
ing, import substitution or trade balancing. However, compliance with the requirements
of a Party to locate production, provide a service, train or employ workers, construct or
expand particular facilities or carry out research and development in its territory are
specifically permitted.
3. **Senior Management and Boards of Directors.**

No Party may require that an enterprise incorporated or organized under the laws of a Party appoint to senior management positions individuals of any particular nationality. A Party may, however, require that a majority of the board of directors, or any committee thereof, be of a particular nationality or resident in the territory of the Party, provided that the requirement does not materially impair the ability of the investor to exercise control over its investment.

4. **Reservations and Exceptions.**

Each Party made specific reservations to the provisions relating to national treatment, MFN treatment, restrictions on performance requirements and senior management and boards of directors, in some cases with specific liberalization commitments. These reservations and any applicable liberalization commitments are contained in Annexes I to IV of NAFTA. Some reservations relate to existing non-conforming measures maintained by a Party and serve to grandfather such provisions, whereas other reservations relate to measures a party currently maintains or may adopt in the future. All existing non-conforming measures of federal governments are grandfathered. Those of a state or province are grandfathered for a period of two years and thereafter must be specifically identified in the appropriate annex to NAFTA in order to retain their grandfathered status.

As did the United States and Canada, Mexico made a number of reservations to its obligations under Chapter 11, particularly in sensitive or strategic sectors. Some of these reservations are reflected in the investment restrictions contained in the FIL which have been discussed above.

5. **Transfers, Repatriation of Investments and Dividends.**

Subject to equitable, nondiscriminatory and good faith application of its law relating to bankruptcy and insolvency, securities regulation, criminal or penal offenses, reports of transfers of currency or other monetary instruments and enforcement of judgments, no Party may prevent an investor of another Party from making transfers relating to an investment in the territory of the Party, including profits, dividends, interest, capital gains, royalty payments, management fees, technical assistance and other fees, returns in kind and other amounts derived from the investment, as well as proceeds from the sale or liquidation of an investment.

6. **Expropriation and Compensation.**

No Party may directly or indirectly nationalize or expropriate an investment of an investor of another party except for a public purpose, on a nondiscriminatory basis, in accordance with due process of law and international law and on payment of fair and adequate compensation.

7. **Special Formalities and Information Requirements.**

Parties are not prevented from adopting or maintaining a measure that prescribes special formalities in connection with the establishment of investments by investors of another Party, such as a requirement that investors be residents of the Party or that investments be legally constituted under the laws or regulations of the Party, provided that such for-
malities do not materially impair the protections afforded to investors under this chapter. A Party may also require an investor of another Party to provide routine information concerning its investments in its territory solely for informational or statistical purposes, subject to an obligation to keep such information confidential.


No Party is prevented from adopting, maintaining or enforcing a measure otherwise consistent with Chapter 11 of NAFTA that is considered appropriate to ensure that investment activity is undertaken in a manner sensitive to environmental concerns. It is also recognized that health, safety or environmental standards should not be lowered by a Party to encourage investment in its territory. If a Party considers that another Party has offered such an encouragement, it may request consultations with such other Party.

9. Dispute Settlement.

Without prejudice to the rights and obligations of the Parties under the general dispute settlement procedures under Chapter 20 of NAFTA (Institutional Arrangements and Dispute Settlement Procedures), Section B of Chapter 11 establishes a mechanism for the settlement of investment disputes arising as a result of a Party’s breach of its obligations under the investment provisions of NAFTA, through international arbitration. Unlike the general dispute settlement procedures, however, which may be invoked only by a Party, the dispute settlement procedures under the investment chapter create rights which may be invoked by any individuals or enterprises.