



## Client Alert

### Reforms to the PEMEX-PIDIREGAS Regime.

In response to current economic conditions in Mexico and concerns over the growing debt obligations of Petróleos Mexicanos ("PEMEX"), the Mexican Congress, in October 2008, unanimously approved amendments to the Federal Budget and Fiscal Responsibility Law that limit PEMEX's participation in the Deferred Impact Status Projects or PIDIREGAS Projects (Proyectos de Impacto Diferido en el Registro del Gasto or "PIDIREGAS projects" for their initials in Spanish), which had until then provided a mechanism for off balance sheet financing by PEMEX of infrastructure development projects. The Mexican government issued a decree (the "Decree") on November 13, 2008 to implement these changes. Please note that the information provided herein is prepared for informational purposes only and is not intended as legal or business advice.

As a result of these amendments, (a) PEMEX Investment Expenditures will no longer be counted for purposes of balancing the Federal budget, thereby releasing additional government funds for other priority projects; (b) PEMEX's current PIDIREGAS commitments will now be considered direct public debt rather than contingent debt obligations; and (c) PEMEX will not be permitted to undertake further PIDIREGAS authorizations and projects.

As discussed herein, the Decree also effects certain new exceptions to government procurement rules for contracting preparatory services for projects, and modifies the Stabilization Fund for PEMEX Infrastructure Investment.

Lenders and sponsors participating in PIDIREGAS projects with PEMEX will want to analyze the new treatment of PEMEX PIDIREGAS commitments as well as other changes to the PEMEX financial and budgetary regulations compared to those of other federal public entities, such as the Comisión Federal de Electricidad. These issues are discussed in greater depth below.

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### I. Background.

On December 21, 1995, Article 18 of the Public Debt Law (“Public Debt Law”) and Article 30 of the abrogated Federal Public Budgetary, Accounting and Expenditures Law (“FPBAEL”) were amended to create a new category of long-term contingent public debt to support priority infrastructure projects that would generate revenue for their own funding, creating the Deferred Impact Status Projects or PIDIREGAS program.<sup>1</sup> In 2006, the Budget Law was enacted, abrogating the FPBAEL and regulating the PIDIREGAS program in Article 32 of that law.<sup>2</sup> Specific rules for obtaining authorization for PIDIREGAS projects were set forth in Regulations of the FPBAEL (the “Regulations of the FPBAEL”)<sup>3</sup> and in the Manual of Federal Budgetary Rules for the Federal Public Administration (the “Budgetary Manual”).<sup>4</sup> Those rules were later replaced by the Regulations of the Budget Law (the “Regulations of the Budget Law”) published in the DOF on June 28, 2006, which remain in effect.

Although Article 18 of the Public Debt Law does not specifically define what constitutes a PIDIREGAS project, it does set forth the relevant funding treatment for such projects, as follows: *“Obligations derived from funding of long-term productive infrastructure projects related to priority activities and, as a result of which the relevant federal public entities acquire goods or services in any form which generate sufficient cash flow to re-pay such obligations shall, with the prior approval of the Ministry of Finance and Public Credit (the “Ministry of Finance”) under the terms of Article 30 of the FPBAEL [now Article 32 of the Budget Law], only be counted for purposes of this Law, as direct liabilities to be paid during the current or the next fiscal year. Any remaining amounts shall be considered contingent liabilities, until the funding has been fully paid to the extent such amounts are available.”*

Based on this framework, PIDIREGAS projects must generate revenues to meet their own payment obligations and federal

funds are expended only following the satisfactory completion and acceptance of the projects. Given that such projects generate their own funds for repayment, the PIDIREGAS projects qualify as Productive Infrastructure Projects, thereby meeting the requirements of Article 18.

Please note that the concept of “productive infrastructure projects” referred to above is different from the concept of “substantial productive activities” (actividades sustantivas de carácter productivo) set forth in Article 51 of the PEMEX Law (“Ley de Petróleos Mexicanos”), which remains to be defined by the PEMEX board.

**A. Types of PIDIREGAS projects.** In accordance with Article 32 of the Budget Law, PIDIREGAS projects are classified as either direct or contingent obligations of the sponsoring public entity. Projects are considered direct investments if the relevant federal public entity is obligated to purchase productive assets that have been built to its satisfaction. The acquisition of productive assets is only permitted to the extent that they generate sufficient revenue to pay project obligations and related expenses. Projects are considered contingent investments if the project is not primarily directed at constructing infrastructure assets to be purchased by the federal public entity and any purchase obligation is contingent upon breach by such federal public entity of its obligations or the occurrence of a force majeure event.

**B. Use of Revenues.** Revenues generated by each project must first be used to pay: (i) tax obligations, (ii) material investments, (iii) financial costs and (iv) operation and maintenance and related expenses of the project.<sup>5</sup> In the case of Direct Investments, once the foregoing amounts have been paid, the federal public entity may use funds equal to one year of the net present value of the cash flow over the remaining useful life of the project (using

<sup>1</sup> DOF dated December 21, 1995.

<sup>2</sup> DOF dated March 30, 2006.

<sup>3</sup> The Regulations of the FPBAEL were published in the DOF on November 18, 1981 and Art. 38-A was amended pursuant to DOF dated June 25, 2001.

<sup>4</sup> The Manual was amended on March 31, 1998, April 20, 1999 and on May 4, 2000. There are no material differences resulting from such amendments, which were issued purportedly to clarify certain aspects of the Manual.

<sup>5</sup> Article 32 of the Budget Law.

the same discount rate that was used in the financial evaluation during the approval process) for other projects and programs. Any remaining revenues are transferred to a liquid reserve for payment of project debt obligations in subsequent years. If the balance of this reserve exceeds the amounts to be paid under the financing, such surplus may be used to fund programs or investment projects other than PIDIREGAS projects.

**C. Effect on Public Finances.** Public entities have the obligation, in coordination with the Ministry of Finance, to implement mechanisms to lessen the effect on public finances of anticipated increases in payments of principal and interest for PIDIREGAS projects in subsequent tax years.

**D. Projects set forth in the Presupuesto de Egresos de la Federación (the “Federal Budget”).**

PIDIREGAS projects must be authorized in a special section of the Federal Budget relating to contracts for public works, acquisitions, leases and services. Any commitments that are not specifically covered in the Federal Budget have a preference over other expenditures, but are subject to yearly budgetary availability. As a result, concerns arose as to whether federal public entities would, from year to year, have the necessary financial resources to fulfill their long-term agreements and financing commitments.

## II. Importance of the Decree.

The Decree addresses the concerns detailed above relating to the PIDIREGAS program. Among other measures, the Decree amends the legal and financial regulations applicable to PEMEX's infrastructure investments to reduce PEMEX's exposure to PIDIREGAS projects. The Decree is divided into three main parts:

**A. PEMEX Investment Expenditure and Balanced Budget.** The Budget Law requires that the draft Federal Budget prepared by the Ministry of Finance be balanced.<sup>6</sup>

Due to the current economic and social conditions in Mexico, it was anticipated that the Federal Budget may show a deficit.<sup>7</sup> In such event, the Ministry of Finance would have to justify the deficit and provide information with respect to the projected duration of the deficit and actions necessary to balance the budget.

To avoid this, the Decree amends Article 17 of the Budget Law to require that PEMEX Investment Expenditure not be counted for purposes of a balanced budget, thereby permitting PEMEX investments to be evaluated on their own merits, irrespective of other uses of budgetary resources.

**B. Budgetary nature of the PEMEX Investment**

**Expenditure.** The Decree also amended Article 32 of the Budget Law to prohibit PEMEX from undertaking additional PIDIREGAS projects. As a result, the entire amount of future investment will henceforth be considered direct liabilities of PEMEX, irrespective of when payment becomes due.

The Decree also requires the Strategy and Investment Committee of PEMEX to issue guidelines for the evaluation of investment projects to assure, among other things, that those projects funded by obligations which constitute public debt generate sufficient cash flow to cover such obligations and the accompanying public debt cost.

**C. Acknowledgement of PIDIREGAS projects**

**liabilities by PEMEX.** The Decree requires, no later than January 31, 2009, that PEMEX recognize as direct public debt for accounting and budgetary purposes all financial commitments for projects authorized before the entry into force of the Decree, whether the projects are in operation or under construction. In the latter case, PEMEX must recognize as direct public debt only the corresponding investment actually made which effectively eliminates the off balance sheet accounting created by PIDIREGAS commitments.

<sup>6</sup> Article 17 of the Budget Law.

<sup>7</sup> A budgetary deficit is defined in the Federal Budget Law as “the financing that covers the difference between the amounts set forth in the Income Law and the Federal Budget and the difference of the income and expenses in the budgets of federal entities.”

PEMEX is required to formalize such recognition within the 2009 tax year, in order to execute any necessary agreements with relevant third parties and financial vehicles. PEMEX may opt for subrogation, assignment of debt or other legal mechanisms through which the corresponding obligations will be fully paid. Finally, PEMEX may conduct transactions or use goods, if any, that are required for the funding of such recognitions.

Finally, the Budgetary Manual will be modified to incorporate these changes to the Budget Law.

### III. Other Issues deriving from the Decree.

#### A. Procurement.

- i) The Decree introduced other important changes in the legal framework for public procurement of infrastructure and services, which now permit companies that have performed preliminary work or that have prepared technical studies for projects to be procured by federal public entities to bid for the construction or implementation of such projects. This measure aims both to encourage greater participation in the planning stages of projects and to ensure that those companies which have relevant expertise may participate in the bidding process.
- ii) The Decree also amended the Budget Law to provide that in cases where bidding under the Law of Acquisitions, Leases and Services of the Public Sector (*Ley de Adquisiciones, Arrendamientos y Servicios del Sector Público*) and the Mexican Public Works and Services Law (*Ley de Obras Públicas y Servicios Relacionados con las mismas*) appeal a final award, the suspension will only be granted at the request of an interested party.

**B. Stabilization Fund for Infrastructure Investment.** Finally, the Decree amends Article 19 of the Budget Law to establish that PEMEX may use fifty percent of the accumulated resources in the Stabilization Fund for Infrastructure Investment at the close of the previous tax year for the expansion of refining infrastructure in Mexico. Additionally, the Second Transitory Article of the Decree provides that, between 2009 and 2011, thirty percent of “the general purse” surplus must be utilized for investment projects in the Federal Budget.

The Stabilization Fund may only be used for substantial productive activities of PEMEX (*actividades sustantivas de carácter productivo*) referred to in item I.

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