

Energy Reform Flash

Far-reaching reform of the sector which could prompt large investments and increase potential growth

- The energy reform bill could be a turning point in the history of energy in Mexico. While the secondary regulations are yet to be known, the reform appears to be an efficient mechanism for attracting large amounts of investment to the country, in turn increasing the potential growth rate.
- The vote is expected to be made in the Senate as early as tomorrow, and it is likely to be approved with the support of the PAN and PRI. It would then move on to the House of Representatives for discussion and debate.
- The main measures proposed in the reform include:
 - ✓ The broad range of contracts for extracting oil (i.e. with considerations in cash, as a percentage of profit, as a percentage of production, and in licenses with transfer for consideration once it has been extracted from the subsoil). Individual companies are allowed to register the expected profits of the contracts for accounting and financial purposes. Furthermore, the licenses mechanism means that companies no longer have to depend on PEMEX efficiencies in order to commercialize hydrocarbons. This factor is extremely important in promoting private investment.
 - ✓ The creation of an oil saving sovereign fund in which the Bank of Mexico will act as a trustee. Nonetheless, the accumulation in this fund is expected to be slow because the resources received are applied first to cover adjustments in public finances, transfers to States, to maintain the oil revenue from the Federal Government in the same proportion of GDP as in 2013, and will also be able to finance pension liabilities, and science and energy sector investment projects, inter alia. Public savings in the fund can only be used in the expenditure budget if approved by two thirds of the lawmakers present. This is a positive change as it will reduce the possibility of extraordinary oil revenue being spent with political criteria.
 - ✓ The legal capacity of the regulatory bodies is strengthened, and others are created to oversee the electrical distribution network and the gas pipelines. The shift in focus from PEMEX and CFE towards productive State companies which have the object of creating economic value and which will compete with private companies.
 - ✓ There are certain elements which have not yet been addressed in detail, such as PEMEX's capacity to choose which fields it will exploit, the criteria to define what kind of contract they will use in each case, and the different regulations which will be drawn up within a period of 4 months starting from the coming into force of this decree. Thus, by mid 2014, the regulatory framework could be ready, allowing inflows of private investment by late 2014 or early 2015.
 - ✓ Transparency requirements in contracts are set out, such as the method of assignation, considerations, and the contract itself.
 - ✓ The bill allows private generation of electricity, but not its distribution.

Legal changes

The legal changes through which the aforementioned elements are materialized are indicated as follows. As we said, some of them deal with how the energy sector will operate and others address the new regulatory and grids operation scheme.

- **Reform of Arts. 27 and 28 of the Constitution to allow companies to invest and to operate in the national energy industry.** It is considered that: i) the exploration and extraction of hydrocarbons and radioactive minerals, control of the national electricity grid and electrical transmission and distribution, alone are exclusive strategic activities of the State; ii) the granting of hydrocarbons concessions in the subsoil, electrical transmission and distribution continues to be forbidden (although the concept of the license is introduced, which, in economic terms, can be very similar); iii) and the Government will carry out the exploration and extraction of hydrocarbons through assignments to state companies or **contract** with them or **with individual companies** and will also enter into contracts with individuals for them to take part in electricity activities.
- **Private investment and promotion of national content.** Under contracts, private investment is allowed in: i) the exploration, extraction, refining, transport, storage and distribution of hydrocarbons and of their derivatives; ii) in electrical generation and commercialization activities; iii) the bases will be established to promote the respective national content.
- **Contractual modes in hydrocarbon exploration and extraction.** The Government will define the type of contracts which are most appropriate for it to maximize its revenues. These types may be: i) services contract with cash payment; ii) shared profit; iii) shared production; iv) license with transfer of consideration of the property once they have been extracted from the subsoil; v) combination of the above.
- **Government ownership of hydrocarbons in the subsoil and reporting of contracts signed.** Government or private companies which enter into contracts are allowed to report the corresponding contract and the expected profit for accounting purposes, while the hydrocarbons in the subsoil are determined to be the property of the Nation. This is a crucial element for the country to be efficient at drawing private investment to the sector.
- **Priority of energy sector against other activities.** Existing and new mining concessions will not have rights for the exploration and concession of hydrocarbons.
- **Transparency in hydrocarbon exploration and extraction contracts.** Transparency obligations are established in the contract tendering and award processes, which any interested party will be able to consult, and it is also stipulated that it will be compulsory to disclose payments and considerations.
- **Powers of government bodies in hydrocarbon exploration and extraction contracts.** The Energy Secretary (SENER) will be in charge of designing contracts; the SHCP will establish the fiscal conditions of the calls to tender and contracts; and the National Hydrocarbons Commission (CNH) shall be authorized to make calls to tender, award contracts to successful bidders, manage contracts and supervise development plans.
- **"Round Zero" or preliminary phase in which Pemex first chooses the areas and fields in which it will operate.** Pemex will make a request to SENER for the exploration areas and fields where it has carried out commercial discoveries or investments in exploration and which it wishes to operate, in addition to keeping the rights of the fields under production. The SENER will issue the corresponding resolution for the request within a period of 6 months from the request date to the PEMEX.
- **Oil savings sovereign fund (Mexican Oil Fund).** This fund will receive and manage oil revenue from assignments and hydrocarbon exploration and extraction contracts. It will have a Technical Committee made up of the Secretaries of the SHCP and of the SENER, the governor of the Bank of Mexico, and two independent members appointed by the Federal Government and approved by the Senate. The Bank of Mexico will be the fiduciary agent of the Fund. This Fund is a positive element of the Reform. Nonetheless, the accumulation in this fund is expected to be slow because the resources received are applied first to cover adjustments in public finances, transfers to States, to maintain the oil revenue from the Federal Government in the same proportion of GDP as in 2013; and when the fund has assets of higher than 3% of GDP, it will also be able to finance pension liabilities, and science, technology and energy sector investment projects, inter alia. The

accumulated balance of public savings in the fund can only be used in the expenditure budget if approved by two thirds of the lawmakers present. When the balance of public savings in that fund is higher than 10% of the GDP, the real financial return will be transferred to the Treasury.

- **New grid operators.**
National Natural Gas Control Center (Centro Nacional de Control del Gas Natural, CENEGAS). This decentralized public body is created to operate the national gas transportation pipeline and storage system and the Energy Regulation Commission (**CRE**) is authorized to establish the regulation in respect of access to the natural gas pipeline infrastructure.
National Energy Control Center (Centro Nacional de Control de Energía, CENACE). The CENACE is created to maintain the operational control of the national electricity system, and the SENER will be authorized to establish the operating terms of the electricity market.
- **Strengthening regulatory energy agencies.** The **CNH** and the **CRE** will be decentralized bodies of the SENER which are independent from a technical and management standpoint, and are self-sufficient for budgetary purposes. Their commissioners will be proposed by the Federal Government and approved by the Senate.
- **National Industrial Security and Environmental Protection Agency (Agencia Nacional de Seguridad Industrial y de Protección al Medio Ambiente).** This agency is created as a decentralized body of the Environment and National Resources Secretariat, with the purpose of regulating and supervising hydrocarbon sector installations activities in terms of security and environmental protection.
- **Focalized subsidies.** The Executive Government will offer the House of Representatives a program to replace general subsidies with subsidies focused on energy commodities.
- **Private participation in the electricity sector.** Public and private investments are allowed to coexist in electrical generation and commercialization.
- **Conversion of Pemex and CFE into productive State companies.** Their object will be to create economic value and to increase Government revenue. Thus a special budgetary regime will be created for these companies; they will be subject to a financial balance and a ceiling of personal services, although the remuneration will have a special regime in keeping with the best practices in the sector. Labor rights of the workers in these companies will be respected.

By addressing the subject of hydrocarbons and electricity, the Energy Reform will bring about a far-reaching transformation of Mexico's electricity sector, given that from now on not only will private companies be able to invest and operate in the sector, but also the regulatory framework can be changed and adapted in order to ensure that the energy market works more efficiently. This will mean that many of the powers formerly held by state-owned energy agencies will be taken over by the proposed new regulatory agencies. Therefore, the Reform makes a contribution on two fronts: on the one hand, it allows for growth in the electricity sector, and on the other, it promotes an efficient energy market which can help to increase Mexico's economic efficiency. If it is properly implemented, the result will be a significant increase in the country's potential growth rate.