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# Economic Watch

## Mexico

# Energy reform: Constitutional changes that maintain the State's stewardship and promote investment

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Economic Analysis

Mexico

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- The energy reform initiative presented on August 12, 2013 by the Federal Executive proposes changes to articles 27 and 28 of the constitution aimed at both enabling the State to subscribe profit-sharing contracts with the private sector (Art. 27) and eliminating the state monopoly in the energy sector (Art. 28).
- The most important aspect of the energy reform bill is that it seeks to permit private sector participation in the exploration and production of hydrocarbons solely through the assignment of profit-sharing contracts, and not through concessions, as some market players were expecting.
- In order to maximize the likelihood of the bill being passed, the reform bill refers to the constitutional text introduced by president Lázaro Cárdenas in 1938 when the oil industry was nationalized, where associations with private companies were permitted under profit-sharing contracts.
- According to the Federal Public Administration, the reform of the energy sector would generate nearly 1.0% more economic growth by 2018.
- In addition, it envisages granting permissions to the private sector to enable it to participate in basic petrochemical activities, refining, transportation, storage, distribution and commercialization of hydrocarbons and their by-products.
- In order to have a proper assessment of the reform, details about the profit-sharing contracts must be known; if they are designed appropriately, they will be as effective as concessions to attract private investment.
- The secondary legislation governing contracts or permissions must offer internationally competitive conditions in order to draw investment from the sector's leading companies.
- Should the lower fiscal burden on Pemex envisaged in the reform bill materialize, this firm would have more management and execution capacity.
- The reform bill seeks to increase the capacity and diversification of electricity generation by permitting its sale among private sector participants, while the State maintains control over the transmission and distribution segments.

## The energy sector reform bill

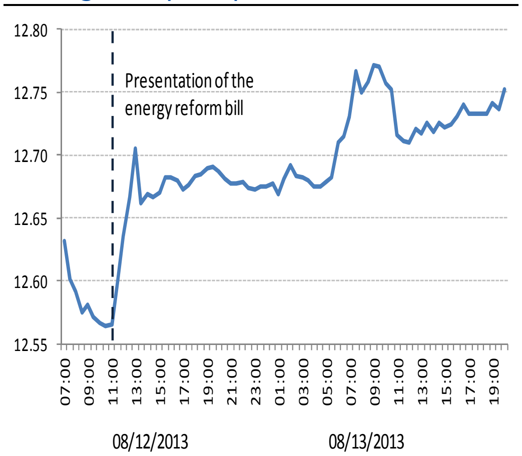
In relation to the exploitation of hydrocarbons (oil and gas), the energy reform bill seeks to amend the country's constitution by envisaging private sector participation solely through the assignment of profit-sharing contracts; the business model based on concessions has not been proposed. In addition, with the assignment of special permissions granted by the Federal Executive, private sector players would be allowed to take part in the following areas: basic petrochemical activities, refining, transportation, storage, distribution and commercialization of hydrocarbons and their by-products. Nevertheless, how the contracts or permissions would be assigned is nowhere mentioned in the energy reform bill; these details would be addressed by the secondary legislation.

As for the electricity sector, the reform bill seeks to increase generation capacity and diversification by permitting the sale of electricity among private sector participants in an integrated market scheme. It also envisages that the State would maintain the ownership of the transmission and distribution segments. Moreover, in order to bring about the lowest possible electricity rates, an independent operator has been proposed to control the access to the transmission grid, which, in turn, would be governed through rules that favor the dispatch of electricity based on cost merits. Another aspect contemplated in the reform bill refers to a reduction in distribution losses of around 10.0% or more according to the international experience in electricity sector restructurings, but this situation would be unlikely to materialize unless the State enforces the rule-of-law against non-technical electricity losses.

## Market reaction

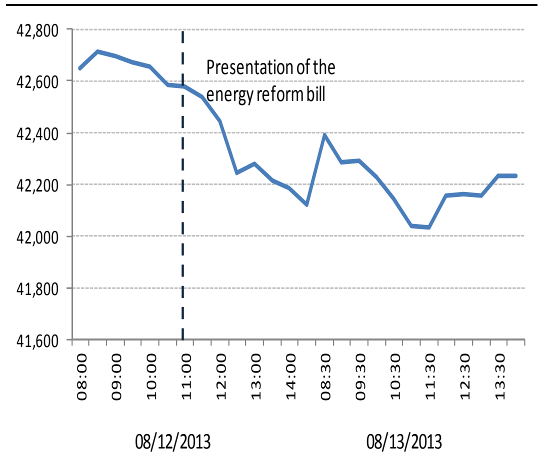
In the hours before the presentation of the reform bill, the stock and government bond markets began to report gains, while the exchange rate appreciated to nearly 12.55 pesos per dollar. However, as soon as the reform was presented, the financial markets lost part of those gains and the exchange rate depreciated to levels around 12.70 pesos per dollar. The day after the reform's presentation, the financial markets showed no relevant correction and remained near previous levels. This behavior may be due to a lack of details about the initiative and, therefore, to the uncertainty about its scope. The reaction could also be explained by the fact that concessions have not been included in the bill.

Chart 1
**Exchange rate (pesos per dollar)**




Source: BBVA Research with data from Bloomberg

Chart 2
**Mexican stock market index**




Source: BBVA Research with data from Bloomberg

## Assessment

The reform bill is no doubt a major step forward compared to the current situation of the energy sector in Mexico. The fact that a constitutional amendment is being proposed to allow private investment represents a major structural change that will lead to significant benefits for the economy, should it be passed.

A more comprehensive and appropriate assessment cannot be made until the details of the accompanying secondary legislation are released, which will define several fundamental aspects that remain open. In particular, the form adopted by the profit-sharing contracts needs to be known. In our opinion, the fact that the bill seeks to attract private investment through this type of contracts and not through concessions is not necessarily a disadvantage, since contracts similar to those of concessions can be designed.

In our view, in order to strongly encourage the participation of private sector players with efficient production processes, the secondary legislation governing the contracts or permissions must offer internationally competitive terms, given the opportunity cost for transnational energy companies to invest in other parts of the world. Only in this way, with the participation of this type of companies, will access to technical knowledge and human capital be possible, given the major challenges posed by the exploitation of both unconventional resources and hydrocarbons in deep waters.

Although the lower fiscal burden on Pemex envisaged in the reform bill would result in greater management and execution capacity for this company, the improvements in operational efficiency will be slower, by not being subject to a level playing field with the rest of the players. Should the reform be passed, one benefit mentioned is oil production reaching 3.0 million and 3.5 million barrels a day by 2018 and 2025, respectively. However, the higher costs of producing oil progressively more difficult to extract could seriously hinder the achievement of these goals.

As for the electricity sector, although the CFE will compete with other producers in the generation segment, the reform does not consider breaking it up into several companies in order to encourage competition in the sector. Consequently, effective regulation on this company will be necessary to meet the goal of rendering competitive electricity rates. The secondary legislation must foster, among other things, the investment in renewable energy to honor the country's sustainable development and climate change commitments.

The Federal Public Administration estimates that by encouraging investment in new areas, the energy reform would generate nearly 1.0% more economic growth by 2018 and approximately 2.0% more by 2025. There is no doubt that the contribution to growth would be significant and would increase gradually as the new scheme becomes consolidated and investment in the sector grows.

In order to independently assess the impact of an oil reform on growth, BBVA Research Mexico estimates how more sustained investment in this industry could generate greater annual growth in the medium term. Permanent sustained growth can be described as potential growth, which would increase as investment continues to grow at a faster sustained pace in the following years. Specifically, a counter-factual scenario being considered is an increase in investment of around an additional five billion dollars per year as a result of the oil reform, so that the average investment in the economy would increase by 2.0% per year on average. As a result, economic growth could increase permanently by around 0.5% from the moment investment reaches the aforementioned behavior in a sustained way. However, this is a conservative estimate, as it does not take into account the possible increases in productivity resulting from companies facing lower energy costs.

We should bear in mind that a constitutional amendment requires a two-thirds majority in Congress. We believe that the chances of the reform being passed are very high, as it will be backed by the PRI and even the PAN, which even presented a more liberal bill than the government's.