

Economic Watch

Mexico

The secondary legislation in the energy sector will bolster oil revenues if the private sector eagerly participates

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Economic Analysis

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- On April 30, the government sent proposals for secondary legislation to Congress to complement the changes to the Constitution passed a few months ago.
- The government, PRI and PAN have expressed their intention to approve the secondary laws in the extraordinary session of July, once the secondary legislation for the political and telecommunications reforms are passed.
- Altogether, modifications or additions will be made to 21 laws.
- This document outlines the main aspects of the proposals; in the next few days we will publish a more detailed analysis.
- The economic criterion for awarding hydrocarbon exploration and extraction contracts, as well as the progressivity in profit oil sharing, will strengthen fiscal revenues.
- To make the country's hydrocarbon sector attractive to foreign direct investment, the fiscal burden will have to remain close to the world average of its shares of net profits.
- Although it would have been better if requirements for minimum national content had not been imposed, the regulations presented to Congress will not significantly hinder the flows of direct foreign investment into the energy sector.
- The proposals for secondary legislation make the inputs supply to the public sector flexible, but it could be improved by incentivizing price competition.
- To mitigate the impact on public finances, Pemex's **fiscal burden will be gradually** reduced from 79% to 65% of its revenues over a 10-year period.
- The savings which will enable the Mexican Oil Fund to accumulate over time will only be possible with a bigger oil production platform.
- The national electricity grid will have to be expanded in a coordinated fashion with electricity generation projects based on renewable energy sources.

The secondary laws initiatives of the energy reform

The proposed secondary legislation in the energy sector consists of 21 laws (12 of which are modifications to existing ones, while 9 will be new). These laws are grouped in nine blocks: 1) Hydrocarbons; 2) Electricity; 3) Geothermal energy; 4) The National Agency for Industrial and Environmental Protection of the Hydrocarbon sector; 5) Productive State Companies; 6) Regulators and The Organic Law on the Public Federal Administration; 7) Fiscal; 8) The Law on the Mexican Oil Fund for Stabilization and Development; and 9) Budget.

The hydrocarbon law allows the participation of private sector agents (both Mexican and foreign) in both exploration activities and extraction of oil and other hydrocarbons. These two activities, which will continue to be defined as strategic, will be either allocated to Pemex, or carried out

through contracts with Pemex or with the private sector. Meanwhile hydrocarbon transformation and logistics will no longer be considered strategic activities as the Ministry of Energy and the Energy Regulatory Commission will be empowered to issue permits to allow private participation.

The Foreign Investment Law proposes that private and foreign investors can participate in the operation, production, transformation, transport and storage of hydrocarbons.

Assessment: positive because this law will facilitate national investment and more importantly the entry of more foreign direct investment (FDI) flows; however, these will only materialize in the medium and long term, thus the greatest benefits will not be seen until the end of this Federal Government Administration term. It is positive that the reform gives the government a wide array of contract options, including licenses, since this will enable the country to be competitive for attracting investment to the energy sector.

The economic criterion for awarding contracts and the progressivity in profit oil sharing will strengthen fiscal revenues

After the Round Zero phase, hydrocarbon exploration and extraction contracts will be awarded by tender. The Ministry of Finance (SHCP, for its Spanish acronym) will determine the financial conditions related to the fiscal regime (profit oil shares, royalties, contract-signing bonds and taxes on operating profits) governing tenders and contracts, aiming for awarding the latter according to an economic criterion only. In other words, the company making the highest bid (in terms of payments to the government) to extract hydrocarbons will be awarded the contract. Moreover, there is a clause for increasing the profit oil share to the government when either the price of oil goes up or when the fields are found to be more productive. Such sliding scale for revenue sharing is a common international practice, in which a greater proportion of oil revenue goes the government when the level of gross production raises.

Meanwhile, these companies' profits would be taxed in the same way other private companies are currently taxed, expecting that most of the hydrocarbon revenue will be obtained from either a tax rate on operating profits or on the gross value of the hydrocarbons extracted. Moreover, as of the 2015 fiscal year, the income tax law will apply to Pemex and its subsidiaries. Nevertheless, the secondary law proposals state that the income derived from Pemex's allocations must not be considered as cumulative income for the purposes of this tax - thus making it possible to allow this firm a reasonable after-tax return on its activities. It is important to highlight that, if this country wants to be attractive to foreign direct investment in the hydrocarbon sector, the fiscal burden needs to remain close to the world average of its shares of net profits.

Assessment: positive for the following reasons:

- i) Given the technological difficulties of extracting hydrocarbons from unconventional fields or deep waters, the participation of private companies with both proven experience in these fields and the resources to make the necessary investments will benefit national oil production and the federal government's revenue stream.
- ii) Awarding contracts on the basis of operating efficiency will strengthen government revenues and also the award criteria will be more transparent.
- iii) An adequate design for the sliding scale for revenue sharing can promote the oil and gas sector's strategic development by incentivizing capital investments in relatively small fields.
- iv) The initiative can get stronger if measures are taken to encourage more participation and hinder coordination during tenders.

In relation to Round Zero projects to be approved by the Ministry of Energy, Pemex will be able to work in partnership with other firms only through contracts awarded by the National Hydrocarbons Commission (CNH, for its Spanish acronym) via a tendering process. To this end, Pemex will be able to suggest the private company with which it would like to form an alliance without this suggestion being binding.

Assessment: positive because the institutional strengthening of the CNH - that the secondary legislation is seeking - will contribute to a tendering process more based on operating efficiency

and much more transparent. Furthermore, by being able to participate in partnership with other companies, Pemex will benefit from their experience in operating unconventional fields.

The law bill makes progress in the flexibility of inputs supply to the public-sector, but it could be improved by incentivizing price competition

When it comes to procurement and public works, the secondary legislation contained in the presidential proposal is focused on giving greater flexibility to Pemex and the Federal Electricity Commission (CFE, for its Spanish acronym). First, the option of using public-private associations arises by reforming Article 10 of this law, since their exclusion from substantive activities of a productive nature has been struck out. This reform means that this instrument can be used for co-investment with the private sector in oil refining, natural gas processing, transport, storage and distribution of hydrocarbons, liquefied petroleum gas and petroleum products, as well as for electricity generation. This change is consistent with the opening up of the energy sector to the private sector and the associated benefits already mentioned.

The most important modification is the exclusion of these two companies from the Public Sector Law on Procurement, Leases and Services, as well as from the Law on Public Works and Related Services. The regulatory framework will be provided by the corresponding specific laws and preference - in line with the spirit of the Constitution - will be given to public tenders with sealed-bid auctions; and by exception other instruments such as restricted invitations or direct awards. Other mechanisms will also be permitted, some of them already proven to have favorable results, such as reverse auctions. However, some of the exceptions to the allocation by public tenders do not seem to be justified. For example, in the case of contract consultants, advisors and research; or maintenance services whose scope, quantities or specifications cannot be known in detail. In contrast, in other categories, the exceptions are justified for reasons of urgency, security or even in order to materialize an advantage like payment making.

Finally, the intention of giving preference to the supply with national content is mentioned in the law initiative with the goal of incentivizing domestic investment and industry. Although the argument in such initiative indicates that the preference for a domestic supplier will apply when there is equality of price and quality, this is not explicitly stated in the text of the laws. On the other hand, this proposed regulatory framework ought to maximize price competition in the tendering processes once quality standards have been met. This issue, as well as a regulation that breaks down unnecessary barriers to entry, should be stipulated in the rules which the respective boards of directors determine on the procedures for supplying goods and services. This is also consistent with the OECD recommendations on these matters.

Assessment: positive but with great room for improvement. The changes are consistent with more participation from the private sector and a more flexible way of operating for the public sector, but it stops short of guaranteeing the best procurement conditions. This is a change in the right direction since both Pemex and the CFE need to be given more flexibility when contracting so that they can be competitive. However, these firms need to have internal controls to minimize corrupt practices.

The national electricity grid will have to be expanded in coordination with electricity generation projects with renewable energy sources

When it comes to the electricity sector, the secondary legislation seeks to expand the national electricity grid's capacity, increase competition in electricity generation and encourage the production of electricity with renewable energy sources. Under the new electricity industry law, one of the Ministry of Energy's roles will be to plan the growth of this grid by taking into account clean energy projects. To successfully foster renewables, the conditions required from participating companies for the interconnection to the electricity grid have to be completely technical and impartial. Moreover, in order to lower electricity rates, the proposal recommends that a National Center for Energy Control (CENACE) be created. This entity will control the access to the grid by electricity generating companies, complying with operating rules which give preference to electricity dispatching based on costs. Buying/selling electricity through long-term contracts is another aspect considered by the secondary legislation to pursue the stability of residential electricity rates.

Assessment: positive because it seeks to create a competitive electricity market which will eventually become a catalyst for the national industry. Contracts for electricity generation will be awarded according to cost efficiency, which is a considerable improvement on the current situation.

To mitigate the impact on public finances, Pemex's fiscal burden will be gradually reduced from 79% to 65% of its revenues over a 10-year period

Pemex will be free to plan its own financing strategy, subject only to coordination with the Ministry of Finance (SHCP, for its Spanish acronym), on an equal basis and at the beginning of each year to avoid its borrowing requirements causing disorderly movements in financial markets. In the case of the CFE, the government will stop charging it a percentage on the value of its assets, and it will only pay income tax (ISR, for its Spanish acronym). Neither company will any longer need to have budgets approved by SHCP, but they will both have to continue reporting their income and expenses to Congress. It will be the latter body, and no longer the SHCP, that will establish the debt ceiling for both companies.

Assessment: although the change in Pemex's fiscal regime needs a transition period so that the Federal Government can gradually reduce its considerable financial dependence on the company, 10 years seems quite long.

The savings which will enable the Mexican Oil Fund to accumulate over time will only be possible with a bigger oil production platform

The Law on the Mexican Oil Fund for Stabilization and Development proposes the creation of a fund to receive and make payments regarding hydrocarbon extraction allocations and contracts. In addition, it is mentioned that the income will be managed by this fund to optimize its yield. This fund will be supervised by the Bank of Mexico. Decisions as to the use of the fund's resources will be made by a technical committee consisting of two representatives of the Federal Government (the Ministers of Finance and Energy), an independent federal government institution (the Bank of Mexico) and four independent members who will have to be approved by the Senate. However, the fund will start to accumulate resources after a 4.7% of GDP is allocated to the Federal Expenditure Budget each year.

Assessment: positive since for many years oil surpluses have been used in transfers to States without making investments in infrastructure, education or healthcare a priority in detriment of the country's economic development. Nevertheless, it would be more desirable if the Fund could immediately start accumulating savings.

The laws on the Federal Budget and Fiscal Responsibility and the General Public Debt propose that the resources from the Mexican oil fund for stabilization and development should constitute a long-term savings fund to be used for investments in technological development and contributions to social spending.

Assessment: neutral since it does not sacrifice some of the use of oil revenue for the expenditure budget for the sake of generating a substantial balance in the savings fund, making the latter only possible through more national oil production.

The rules on minimum national content requirements will not discourage FDI flows into the energy sector

The rules regarding minimum national content indicate that this will rise to an average of 25% in 2025. In addition, a public trust will be set up for small and medium enterprises (SMEs) in the energy sector.

Nevertheless, the rules for national content should not be applied in cases representing an advantage in subsequent tenders. For example, if a tender requires sunk costs, such as the installation of infrastructure for the provision of a service, the national content requirement would put any new participant at a competitive disadvantage when the time comes for renewing such service.

Assessment: neutral since it would have been preferable to have no minimum national content requirement at all. Nevertheless, the proposed limit is less restrictive when compared to other emerging economies which have carried out far-reaching energy reforms.

Conclusions

The proposed secondary legislation for the energy sector dissipates some doubts there were about the depth and scope of the constitutional reform passed in December 2013.

In the realm of hydrocarbons, assuming that the more profitable projects will be allocated to Pemex in Round Zero, the success of the proposals will depend on the entry of companies with proven experience in developing unconventional fields (shale and deep water). This is why the fiscal burden will have to remain around the world average of its shares of net profits. Furthermore, the sliding scale for revenue sharing should be designed in such a way that encourages the strategic development of the hydrocarbon sector by providing incentives for capital investment in relatively small fields.

It is important to bear in mind that, given that the proposal for the Law on Hydrocarbon Revenues states that the SHCP - after having consulted the Ministry of Energy's opinion - will determine the revenues from hydrocarbon operations, Congress should improve the law initiative to provide the participating institutions with more and better tools to supervise the hydrocarbon production of private companies.

As for the electricity subject, a reduction in electricity rates might be possible if the National Center for Energy Control (CENACE, for its Spanish acronym) does in fact governs itself by operating rules which give preference to electricity dispatching based solely and exclusively on costs. Moreover, expanding the national electricity grid will have to take place in an impartial manner, without seeking to benefit any electricity generation firm, including the CFE.

In our opinion, the changes to the corporate governance in Pemex and CFE will enable them to act like private firms by significantly mitigating the political interference in their decision making process. Furthermore, transparency and accountability are two issues which will have to be fostered in order to achieve a more efficient development of the incipient Mexican energy sector. Finally, we should point out that the design of the Mexican Oil Fund and the gradual reduction in the dependence of public revenue on oil production are two subjects with great room for improvement.

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