

## The New Scenario with the Energy Reform



The Energy Reform is one of the most important achievements of the current Mexican Federal Administration. Its potential positive effects will be very relevant to Mexico within the medium and long term from the social and economic points of view.

From the approval of the Constitutional amendments (regarding the energy sector), there is still a long way to go with respect to all the complex topics that should be regulated in the corresponding secondary laws, including the organic laws for the regulatory agencies that have been created or modified.

The Federal Government and the regulatory agencies shall radically shift their processes and activities in order to be aligned with the objectives established in the Reform. For such purpose, new information systems and business processes will have to be put in place, with the challenge to comply with both: the industry regulations and the applicable laws to the Federal Administration.

### Main changes of the Energy Reform

With the Constitutional reform to the energy sector approved by the Mexican Congress in December 2013, a chapter of the Mexican oil industry history is closed, that since 1938 allowed only to the State, through Petróleos Mexicanos (hereinafter referred to as "Pemex"), the execution of all and each of the activities of said oil industry. In general terms, the Reform consists in the following.

According to the amendments to articles 25th, 27th and 28th of the Constitution, the public sector shall have, exclusively on its charge, the strategic areas of exploration and production of oil and all hydrocarbons (hereinafter referred together as "Oil"), but allowing the Federal Government to execute such activities by means of assignments granted to State Owned Productive Companies (*"empresas productivas del Estado"*), or through certain contracts to be

executed with such companies or with the private sector.

According to the Reform, the exploration and production activities of Oil are considered of "social interest" and "public order" and, thus, shall be preferred above any other activity that may be executed on site.

Regarding environment matters, the Reform introduces the concept of "sustainability" to Article 25th of the Constitution, in order to consider the ecological surrounding in the economical development policies, and foresees the creation of the National Agency on Industrial Security and Environment Protection for the Hydrocarbons Sector (Agencia Nacional de Seguridad Industrial y Protección al Medio Ambiente del Sector de los Hidrocarburos).

On regard of subsidies to energy, the Executive Branch is instructed to propose to the Federal Congress a program to substitute general subsidies to focalized ones in the energy sector.

## Legal innovations of the Energy Reform

According to the Reform, Oil (including any other hydrocarbon solid, liquid or gaseous) located in the sub-surface continue to be national property, being prohibited the concessions. As we mentioned before, the exploration and production of Oil is considered strategic and, thus, exclusively in hands of the State, but allowing the Federal Government to execute such activities by means of assignments granted to State owned productive companies, or through certain contracts to be executed with such companies or with the private sector, in terms of the secondary law. The State owned productive companies will also be entitled to enter into contracts with the private sector.

To develop the exploration and production activities, the Reform establishes four types of contracts, which are “among others”:

- a) Service contracts (with payments in cash)
- b) Shared profits (with payments that correspond to a percentage of the profits of the project, percentage not established yet)
- c) Shared production (with payments that correspond to a percentage of the production)
- d) Licenses (with payments made by means of the selling of the Oil, once the same is extracted from the subsoil)

It is also possible to combine the four options herein above mentioned.

Pemex shall submit to the consideration of the Energy Ministry, within 90 (ninety) calendar days following the approval of the Decree, which are currently the areas in exploration and the producing fields, that it is capable to operate through assignments. The Energy Ministry shall have 180 (one hundred eighty) calendar days to decide about Pemex's filling. This is named as “Round Zero” (“*Ronda Cero*”).

It is a very remarkable innovation the fact that Pemex is entitled to continue working in the exploration projects currently in development for a period of 3 (three) years, that may be extended for 2 (two) more years. If the project is successful according to the expected results, Pemex could continue with the production activities; otherwise, the project will be reverted to the State, so it may terminate or reassign the same. If in the process of granting assignments, Pemex's investments may be affected, the same shall be recognized at their fair economic value in the terms that for this purpose establishes the Energy Ministry.

Other activities of the oil industry (this is, transportation, storage, distribution and refinement of Oil) as well as the petrochemical industry, are not part of the strategic activities reserved to the

State and, thus, could be developed by the private sector in the terms that the secondary law establishes.

## The roll of the State in the Energy Reform

### Energy Ministry

Shall be empowered to issue permits for Oil refining and treatment, as well as the processing of natural gas. That is, once extracted from the sub-surface, the Oil may be sold by whoever having legal possession of it, in order to be processed, even within national territory.

### Finance Ministry

Shall be entitled to determine the conditions regarding the fiscal terms of the agreements and bids for exploration and production of Oil issued by the Energy Ministry.

### Regulators

The National Hydrocarbons Commission (Comisión Nacional de Hidrocarburos) and the Energy Regulatory Commission (Comisión Reguladora de Energía) will become “coordinated” regulators.

They will continue as administrative agencies depending on the Energy Ministry, but they will be granted with legal personality, technical autonomy





and some budgetary autonomy, thus, being able to dispose of the income of contributions for their services in the issuance and administration of permits, authorizations, assignments and contracts, as well as services related to the National Hydrocarbons Information Center.

### **National Hydrocarbons Commission**

Shall provide technical support to the Energy Ministry. Besides, it could authorize reconnaissance and superficial exploration services, development of tender bids, declaration of winners and execution of contracts for exploration and production of hydrocarbons, supervising production plans so productivity of Oil fields in time be maximized, as well as the regulation in Oil exploration and production activities.

### **Energy Regulatory Commission**

Shall have power to grant permits for storage, transportation and distribution by pipelines of Oil, gas and other Oil products, and will be responsible for the open access regulation to pipelines and storage, and the regulation of first hand sales of such products.

### **Petróleos Mexicanos (Pemex)**

Shall be transformed from an agency of the Federal Government to a "State owned productive company", whose operation will be based on principles of effectiveness, efficiency, honesty, transparency and productivity according to best practices in the industry. Meanwhile it changes its regime, Pemex may execute contracts with the private sector under the new legal framework. It is set that within two years Pemex shall become a State owned productive company.

The Oil Labor Union (Sindicato de Trabajadores Petroleros de la República Mexicana or STPRM) is excluded from Pemex Board of Directors; thus, disappearing its influence in the decision making process.

Such Board shall be composed by five (5) councils from the Federal Government, including the head of the Energy Ministry, who will preside and have casting vote, and five (5) independent councilors.

It is also stated that Pemex must establish rules of administration, organization, operation, functionality,

procurement procedures as well as the payment regime for its staff, to ensure efficiency, honesty, productivity, transparency and accountability. However, labor rights of workers currently enrolled in Pemex and its subsidiaries will be fully respected. The new criteria for payrolls and benefits will take effect from the establishment of the Reform.

### **Mexican Oil Fund for Stabilization and Development**

This fund shall receive all the income from exploration and production activities, excluding taxes. It will take the form of a public trust that will be incorporated during 2014 and will begin operations in 2015. The Mexican Central Bank (Banco de México) will be the trust fiduciary institution.

The amendment establishes that the Mexican Oil Fund for Stabilization and Development shall, among others,

deliver annually Oil revenue for an amount equal to 4.7% of the Mexican gross domestic product (GDP) to the Treasury Department, in order to destine it to the Federal Budget of each year.

The Fund will have a technical committee formed by the secretaries of Finance, Energy and the Director of the Mexican Central Bank, as well as four (4) independent members who will be designated by the President of Mexico with the approval of two thirds of the Senate Chamber. The chairman of the technical council shall be the Secretary of Finance.

### **National Center for Natural Gas Control**

Within 12 months from the enactment of the secondary law, the President of Mexico must create a public decentralized agency in charge of the operation of the State owned gas transportation grid and the natural gas storage facilities.



## New challenges – New opportunities

The investors shall have to succeed new challenges to become players in the new scenario and participate according to its own expertise.

In this sense, knowledge and experience will be fundamental to the success in the tender bids that will take place in the future.

Some of the more relevant complexities in which a firm like KPMG may give value with its expertise in this industry are the following:

- a) Evaluation of financial information and cash flows, depending on the type of contract to be granted by the Federal Government for each project, and its potential effects in the financial information of the participating companies
- b) Impacts in the fiscal regime
- c) Compliance with the contractual requirements and obligations to report operational and financial information
- d) Compliance of laws and regulations, including those concerning sustainability and environment
- e) Administration of investment projects
- f) Establishment of the optimal labor regime
- g) Establishment of the information systems required for the generation of operational and financial information, with which the compliance of the contracts will be evaluated by the Government

KPMG has the human talent and the knowledge and experience in the Energy Sector that allows us to bring integral solutions with high added value. Our experience in this sector, both in Mexico and abroad, give us a unique perspective of the needs that our clients will face, as well as the solutions to allocate the same in a satisfactory way.



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