

FINANCIAL FLOWS FRAMEWORK FOR THE MEXICAN HYDROCARBON SECTOR

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ACRONYMS

ANSIPA	National Agency for Industrial Safety and Environmental Protection in the Hydrocarbon Sector <i>Agencia Nacional de Seguridad Industrial y de Protección al Medio Ambiente del Sector Hidrocarburos</i>
ASF	Supreme Audit Office <i>Auditoría Superior de la Federación</i>
CEBURES	Publically traded peso denominated bank notes <i>Certificados Bursátiles Bancarios</i>
CENEGAS	The National Center for Natural Gas Control <i>Centro Nacional de Control de Gas Natural</i>
CFE	Federal Electricity Commission <i>Comisión Federal de Electricidad</i>
CIEP	Integrated Exploration and Production Contract <i>Contratos Integrales de Exploración y Producción</i>
CNH	National Hydrocarbon Commission <i>Comisión Nacional de Hidrocarburos</i>
CRE	Energy Regulatory Commission <i>Comisión Reguladora de Energía</i>
DOF	Official Gazette of the Federation <i>Diario Oficial de la Federación</i>
DOSH	Ordinary Hydrocarbons Duty <i>Derecho Ordinario Sobre Hidrocarburos</i>
E&P	Exploration and Production
ECA	Export Credit Agency
FMPED	Mexican Petroleum Fund for Stabilization and Development <i>Fondo Mexicano del Petróleo para la Estabilización y el Desarrollo</i>
IEPS	Special Tax on Production and Services <i>Impuesto Especial Sobre Producción y Servicios</i>
INAI	National Access to Information Institute <i>Instituto Nacional de Transparencia, Acceso a la Información y Protección de Datos Personales</i>
IOC	International Oil Company
NOC	National Oil Company
OECD	Organization for Economic Cooperation and Development
PAN	National Action Party <i>Partido Acción Nacional</i>
PEMEX	<i>Pétroleos Mexicanos</i>
PEMEX-SSPA	<i>Pétroleos Mexicanos - Sistema para la Administración de Seguridad, Salud y Protección Ambiental</i>
PEP	Pemex Exploration and Production <i>Pemex Exploración y Producción</i>



PRI	Institutional Revolutionary Party <i>Partido Revolucionario Institucional</i>
PRD	Democratic Revolutionary Party <i>Partido de la Revolución Democrática</i>
PROFEPA	Federal Attorney for Environmental Protection <i>Procuraduría Federal de Protección al Ambiente</i>
SE	Ministry of the Economy <i>Secretaría de Economía</i>
SEDESOL	Ministry of Social Development <i>Secretaría de Desarrollo Social</i>
SEMARNAT	Ministry of the Environment and Natural Resources <i>Secretaría del Medio Ambiente y Recursos Naturales</i>
SFP	Ministry of Public Administration <i>Secretaría de la Función Pública</i>
SHCP	Ministry of Finance <i>Secretaría de Hacienda y Crédito Público</i>
SNA	National Anti-Corruption System <i>Sistema Nacional Anticorrupción</i>
STPRM	Mexican Petroleum Workers Union <i>Sindicato de Trabajadores Petroleros de la República Mexicana</i>
STPS	Ministry of Labor <i>Secretaría del Trabajo y Previsión Social</i>



1. INTRODUCTION

This report is part of the project “Transparency and Accountability in the Mexican Extractive Industry.” It develops and implements a framework to analyze key financial flows, actors and oversight mechanisms within the Mexican hydrocarbon industry. The goal of the report is to uncover key decision makers and economic transactions in the sector. Explicit, implicit, legal and illicit financial flows and their oversight are considered.

The first section, The Global Hydrocarbon Industry, provides the international context both from a business and regulatory perspective. The second section, The Mexican Hydrocarbon Industry, includes a discussion of oversight mechanisms, legal financial flows, pertinent information on changes under the 2013 Energy Reform, and non-state, non-private sector economic actors. Finally, using the tools developed in the associated report *Theoretical Framework for Financial Flows in the Extractive Sector* and based on analysis of all actors, financial flows, and oversight mechanisms, the report identifies potential for illicit financial flows in the Mexican hydrocarbon industry and where and how they might occur.

This report is based on primary analysis of Mexican hydrocarbon law, published in the Official Gazette of the Federation (Diario Oficial de la Federación, DOF), publically available information on the structure of the Mexican Government, and statistics on tax, debt, contracts, and reserves made public by Pemex and the Ministry of Finance and Public Credit (Secretaría de Hacienda y Crédito Público, SHCP). The report makes use of academic analysis published by Mexican and foreign universities and think tanks, analysis by international organizations including the OECD, Transparency International, and OpenOil, and Mexican and foreign journalism. Finally, the research process included numerous formal (cited as interviews) and informal conversations with experts from the public sector, private sector, and civil society.

2. HYPOTHESIS

Power dynamics and economic transactions between key political, economic and social actors underlie current energy regulation and legislation. The Mexican energy industry regulatory regime was not created for the best possible governance of Mexican energy resources. Rather, it was designed to benefit the interests of key national and foreign energy sector actors.

All types of financial activity represent a flow of power and influence. Because of this, identifying financial flows, both licit and illicit, sheds



light on underlying flows of influence and power. Understanding oversight mechanisms, legal financial flows, state, private sector, community, labor and illicit actors, and moments of opportunity for illicit financial flows offers a unique perspective on the Mexican hydrocarbon industry and can provide useful insights for improving natural resource governance.

I. THE GLOBAL HYDROCARBON INDUSTRY

1. INTRODUCTION

The hydrocarbon industry is distinctive compared to other industries, including other extractive industries, in a number of ways. It has greater risks, costs, and profits than mining. It is more capital intensive and less labor intensive than most forms of mining. The cost of drilling a meter of an oil well exceeds that of drilling a meter of a diamond hole by 10 or 20 times, and oil wells are generally 1000 to 5000m deep, while diamond holes average 500m.¹

Additionally, oil is a strategically important energy source with no close substitute. Oil has wider applications than any other single material, ranging from transport to power generation to petrochemicals. The strategic significance of oil shapes the actions of both consumer and producer countries. For producer countries, oil often dominates the economy and is subject to extensive government intervention. For consumer countries, security of supply is a question of national concern. This shapes consumer country engagement with producer countries and can involve varying degrees of corruption, coercion, and tolerance in the face of producer country abuses.²

The international dynamics of oil are unique. Low-cost reserves are highly concentrated, with 63% in the Middle East. Because the Organization of Petroleum Exporting Countries (OPEC) controls the largest and lowest-cost reserves, the market structure is less competitive than that of most other sectors.³ The wide-ranging geopolitical implications of international oil

1. Carole Nakhle, "Mining and Petroleum Taxation: Principles and Practice" (presented at the Revenue and Mobilization Development Forum, IMF, Washington, D.C., 2011). Hereinafter: Nakhle, "Mining and Petroleum Taxation."

2. There are countless examples of tolerance in the face of abuse on the part of consumer countries. Two articles that deal with this theme are "Oil clouds West's Dealings With Africa Strongmen" in Reuters, July 20, 2006 and "Oil Cash and Corruption" by Ron Stodger in the *New York Times*, November 5, 2006. Source: Charles McPherson and Stephen MacSearraigh, "Corruption in the Petroleum Sector," in *The Many Faces of Corruption: Tracking Vulnerabilities at the Sector Level* (World Bank, 2007).

3. *Supra* note 1: Carole Nakhle, "Mining and Petroleum Taxation."

supply are beyond the scope of this report. However, it is important not to underestimate the lengths governments and companies will go to ensure their slice of the highly lucrative hydrocarbon industry.

DISTINCTIVE CHARACTERISTICS OF THE HYDROCARBON INDUSTRY

1. *High risks, costs, and profits*

2. *More capital intensive than labor intensive*

3. *Strategic significance (oil has no close substitute)*

4. *Low cost reserves are geographically concentrated*

2. TECHNICAL OVERVIEW OF THE HYDROCARBON INDUSTRY

In this report, unprocessed, unrefined hydrocarbons refer to crude oil and natural gas. Crude oil and natural gas lie in underground deposits and must be found, extracted, processed or refined, moved and sold. The hydrocarbon industry is generally broken into two broad phases: upstream and downstream. The upstream hydrocarbon industry includes exploration, development of infrastructure, and production of crude oil and natural gas. The downstream hydrocarbon industry includes the refinement of oil, processing of petrochemicals, transport, storage, import, export and marketing of final products.

UPSTREAM VS. DOWNSTREAM HYDROCARBON INDUSTRY

UPSTREAM

- *Exploration*
- *Development (construction of infrastructure)*
- *Production*

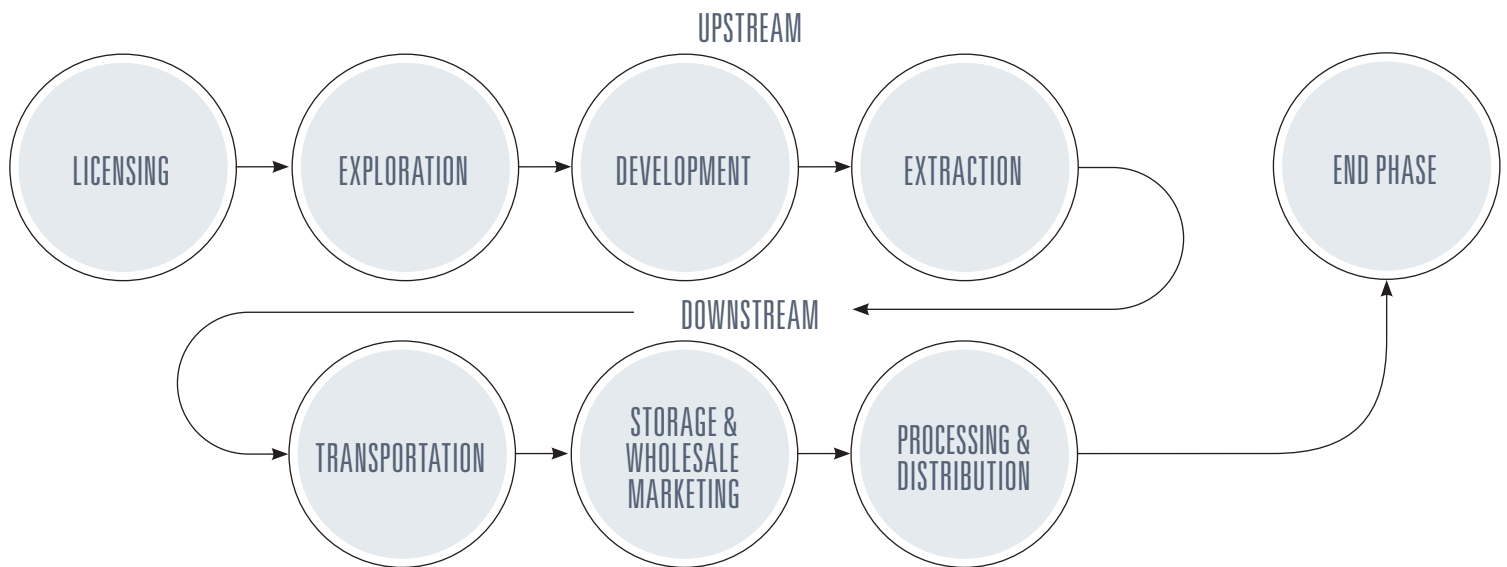
DOWNSTREAM

- *Refining and processing*
- *Storage and transport*
- *Importing/Exporting*
- *Marketing*

The extractive industry value chain presented in the associated report *Theoretical Framework for Financial Flows in the Extractive Sector* applies to the hydrocarbon industry. Financial flows associated with licensing, exploration, development and extraction as well as the end phase or



decommissioning of a site will take place between actors in the upstream hydrocarbon industry. Financial flows associated with transportation, storage and wholesale marketing and processing and distribution will take place between actors in the downstream hydrocarbon industry.



2.1 THE UPSTREAM HYDROCARBON INDUSTRY

The upstream hydrocarbon industry consists of discovery of a hydrocarbon deposit, construction of a production site, extraction of crude oil and natural gas, and eventual decommissioning of the site. Oil and gas deposits may be onshore, offshore in shallow water (less than 500 ft. deep), or offshore in deep water (over 500 ft. deep). The deeper underwater the deposit, the more difficult and expensive it is to access.

Deposits may be “conventional” or “unconventional.” The distinction between a conventional and an unconventional deposit is the manner, difficulty, and cost associated with extracting the oil or gas. Conventional oil and gas can be extracted using traditional oil wells, while unconventional oil and gas require new and emerging technologies to extract. Unconventional oil deposits include those found in oil shale and oil sands. Unconventional gas deposits include tight gas, coal bed methane, gas hydrates, and shale gas (which sits in sand beds).



TIMELINE OF AN OIL OR GAS PROJECT ⁴

SURFACE EXPLORATION

- Usually employs seismic technology, or sound waves, to estimate the location of deposits.

EXPLORATION DRILLING

- Drilling for samples. Often several exploration wells are required to establish exactly what is below the earth's surface.

DISCOVERY AND APPRAISAL

- When exploration drilling is successful, a hydrocarbon deposit is discovered. The chemical compositions and size of the discovery must be determined and the best extraction method must be assessed.

IS IT A COMMERCIAL DISCOVERY, I.E. HYDROCARBONS IN SIGNIFICANT QUANTITIES WITH AN ECONOMICALLY VIABLE EXTRACTION COST? IF YES, CONTINUE DEVELOPMENT

- Of infrastructure to extract the hydrocarbon. The development phase usually lasts several years and is the most capital intensive.

PRODUCTION

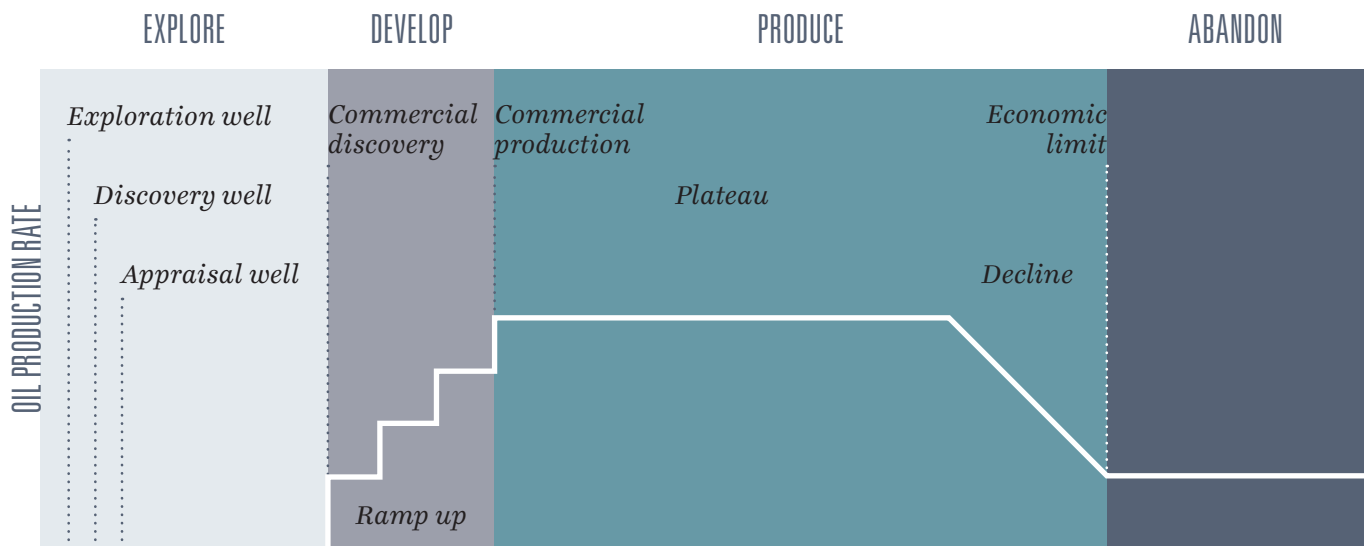
Sometimes decades after exploration begins, oil and gas begin to flow.

- **Ramp up:** production increases as wells enter production.
- **Commercial production:** begins once gas or oil are flowing at the expected rate for about a month. How long commercial production lasts depends on the size of the deposit.

END PHASE

- As the deposit diminishes and production becomes commercially unviable, the project is decommissioned and abandoned. The end phase includes plugging the production wells and restoring the environment to its original state.

EXAMPLE OF AN OIL PROJECT TIMELINE



Source: OpenOil

4. OpenOil, *Oil Contracts- How to Read and Understand Them*, ed. Edition 1 (Creative Commons License: OpenOil UG and the OpenOil booksprint team, n.d.). Hereinafter: OpenOil, *Oil Contracts- How to Read and Understand Them*.

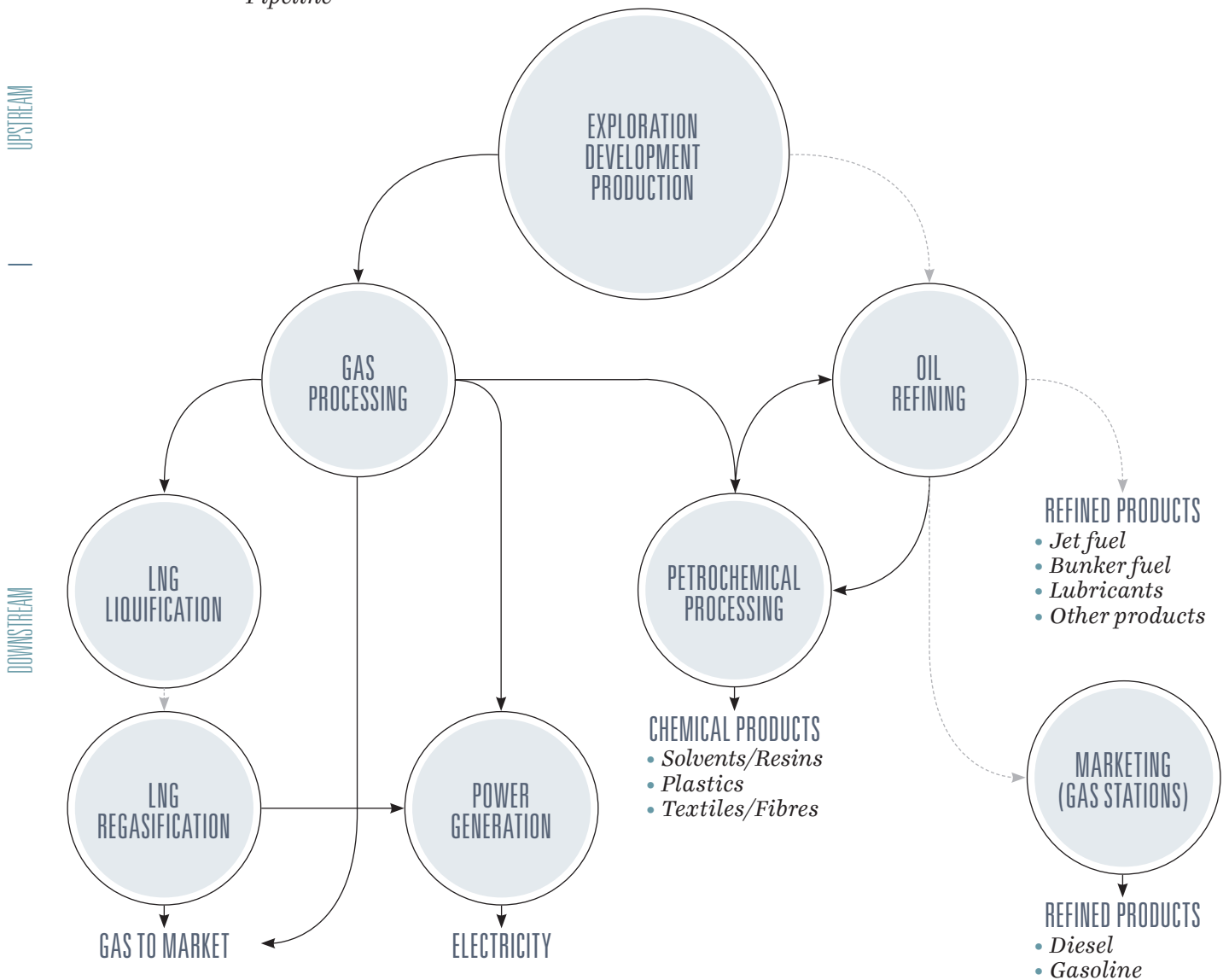


2.2 THE DOWNSTREAM HYDROCARBON INDUSTRY

The downstream phase of the hydrocarbon industry includes all the steps that take the un-refined, un-processed hydrocarbon from the production site to the first consumer. This includes transporting by pipelines, road, rail or boat, storing, refining, processing, and marketing the resource.

DIAGRAM OF THE DOWNSTREAM HYDROCARBON VALUE CHAIN

→ Pipeline



Source: OpenOil



3. OIL COMPANIES

3.1 PRIVATE SECTOR HYDROCARBON VALUE CHAIN COMPANIES

International Oil Companies (IOCs), independent exploration and production (E&P) companies, and a range of companies that provide other goods and services take part in the hydrocarbon value chain.

IOCs are large, privately owned international companies involved in E&P of crude oil and natural gas, as well downstream activities. British Petroleum, Exxon, Chevron, and Shell are examples of IOCs. IOCs are also known as “majors” and are the biggest petroleum companies in the world and among the biggest companies of any industry in term of revenues or capitalization. IOCs have the best access to the expensive cutting edge technology required to develop unconventional oil and gas deposits.

Independent oil and gas exploration and production companies, or independents, operate on a smaller scale than IOCs. Independents generally do not have the capital to develop extremely large hydrocarbon projects and are not involved in the entire upstream and downstream hydrocarbon value chain. Independents have been instrumental in developing shale gas in the United States and will sometimes take over end-of-life deposits or develop deposits that larger companies have abandoned. Andarko in the US is an example of an independent.

E&P companies rely on engineering firms, drilling companies, and rig operators for goods and services required for the extraction of hydrocarbons. Examples include Halliburton, Schlumberger, and Technip. Transportation, refining and trading companies take part directly in the downstream hydrocarbon industry. Examples include Hess, Glencore, Trafigura, and Koch Industries. Additionally, companies in other sectors provide everything from water management services to uniforms to public and private hydrocarbon companies.

3.2 NATIONAL OIL COMPANIES

National Oil Companies (NOCs) are owned, either entirely or in majority, by the state. The first nationalized oil company in the world was Yacimientos Petroliferos Fiscales founded in Argentina in 1922, followed by Petróleos Mexicanos (Pemex), founded in Mexico in 1938. The number of NOCs increased drastically in the 1970s when OPEC was formed. As of 2013, there were more than 100 NOCs, found in almost all oil exporting countries,



many oil importing developing countries, and a hand full of oil importing developed countries.⁵

NOCs are one of the tools a state can use to ensure its share of hydrocarbon industry profits. However, increasing state revenue is rarely the sole motivation for establishing a NOC. They are also used to promote the state's political, social, and economic agenda. NOCs are required to incorporate noncommercial objectives into their operations in a way that private companies are not. NOCs are used to provide employment. They are often required to fund social infrastructure, such as schools and hospitals, and regional development, such as roads and bridges. NOCs can be used as a tool for income transfer, most commonly in the form of subsidized fuel prices. At times, NOCs, using their oil as leverage, have been asked to raise capital for the government for non-oil related activities.

The incorporation of noncommercial objectives is a central argument both in favor of and against NOCs. Those in favor of NOCs argue that noncommercial objectives allow oil riches to benefit society as a whole. Opponents argue that state involvement leads to inefficient overemployment and that social infrastructure and regional development programs are outside NOCs' core areas of competence and could be better executed through other channels. The incorporation of noncommercial objectives limits NOCs ability to raise capital and compete on the international market. Opponents also point out that though NOCs generate cash, they are also extremely cash hungry. Huge oil sector financing requirements crowd out other social spending needs and often go un-met.⁶

Alternately, underinvestment in reserves can lead to stagnation in capacity growth and inability to maintain production levels.

NOCs are highly diverse. Some perform quasi-governmental functions in the hydrocarbon market, such as licensing, awarding concessions and regulating the hydrocarbon industry, while others are purely commercial entities. NOCs have different levels of international exposure. Some, although called "national", are in fact international companies that produce hydrocarbons domestically and abroad. Some NOCs are publicly listed (with the state being the controlling shareholder). Others have major upstream subsidiaries that are publicly listed, while still others are non-listed, fully state-owned companies.⁷

5. "National Oil Companies: Evolution, Issues, Outlook" (presented at the National Oil Companies Workshop: Current Roles and Future Prospects, Washington D.C.: World Bank, 2003). Hereinafter: "National Oil Companies: Evolution, Issues, Outlook."

6. *Ibid.*

7. Transparency International and Revenue Watch Institute, *Promoting Revenue Transparency: 2011 Report on Oil and Gas Companies*. (Berlin: Transparency International, Revenue Watch, 2011).



NATIONAL OIL COMPANIES, AS OF 2011

	PUBLICALLY LISTED NOCs	NOCs WITH LISTED SUBSIDIARIES	NON-LISTED NOCs
COMBINING REGULATORY AND COMMERCIAL ACTIVITIES		<ul style="list-style-type: none"> • KazMunayGas* (Kazakhstan) • Petronas (Malaysia) • CNOOC (China) • CNPC (China) 	<ul style="list-style-type: none"> • GEPetrol (Equatorial Guinea) • QatarPet* (Qatar) • KPC (Kuwait) • SNPC* (Congo) • NIOC* (Iran) • SaudiAramco* (Saudi Arabia) • NNPC* (Nigeria) • SOCAR* (Azerbaijan) • PDVSA* (Venezuela) • Sonangol* (Angola) • Pemex* (Mexico) • Sonatrach (Algeria)
NO REGULATORY ACTIVITIES	<ul style="list-style-type: none"> • Gazprom* (Russia) • Inpex (Japan) • ONGC (India) • Petrobras (Brazil) • PetroChina (China) • Rosneft* (Russia) • Statoil (Norway) 	<ul style="list-style-type: none"> • Sinopec* (China) 	

Source: Transparency International and Revenue Watch Institute, 2011

* Companies in bold are single-country upstream producers, companies not in bold produce hydrocarbons in more than one country.

4. TYPES OF HYDROCARBON INDUSTRY REGIMES

Governments intervene in the hydrocarbon industry to varying degrees. At one extreme are countries that opt for total private enterprise. At the other extreme are countries that opt for a complete state monopoly. Most countries lie somewhere in between the two extremes, allowing involvement of private IOCs in cooperation with the host country's NOC.

4.1 FULLY PRIVATE REGIME

In a fully private regime, the state does not directly participate in the hydrocarbon industry through an NOC. Instead, all hydrocarbon production,



processing and distribution is performed by IOCs. Most OECD⁸ countries have fully private hydrocarbon regimes, while most non-OECD countries incorporate some state involvement. The majority of IOCs are domiciled in OECD countries. They bring employment and dividend flows to the countries in which they are domiciled, making it easier for OECD countries to find public support for private oil enterprise. The United States is an example of a country with a fully private regime. The private enterprise model requires a strong fiscal and regulatory framework that only a stable, powerful government can reasonably enforce.

4.2 STATE MONOPOLY REGIME

In a state monopoly regime, the state NOC has a monopoly over the extraction of hydrocarbons. The state formulates and finances an investment program executed through a NOC, and no IOCs are involved in the extraction of hydrocarbons. State monopoly regimes are found in a small number of oil-rich countries. Saudi Arabia and Venezuela are examples of countries with state monopoly regimes. Countries with monopolistic NOCs view oil as a strategic commodity that must be fully controlled by the government. They argue that direct state participation through ownership is necessary to ensure that a large share of the economic rents associated with hydrocarbon production is returned to the citizens. State monopoly regimes generally coexist with a national development plan focused on self-sufficiency and a political rhetoric of resource nationalism.

4.3 HYBRID PUBLIC-PRIVATE REGIMES

Hybrid public-private regimes allow varying degrees of IOC involvement in cooperation with the host country's NOC. Hybrid public-private regimes may lie anywhere between the extremes of state monopoly and full privatization. IOCs and NOCs have different objectives, capabilities, assets and tolerances for risk. Generally, NOCs have preferential or monopoly access to the below ground resources, while IOCs contribute technical, managerial, and project execution expertise. With respect to downstream industry, even in countries that allow for IOC involvement, many NOCs maintain a virtual monopoly over petroleum refining, transportation, storage, and importation, though this

8. The Organization for Economic Cooperation and Development (OECD) has 34 member countries selected based on the criteria of "like-mindedness" and being a "significant player." Members are the world's richest countries with some degree of neoliberal policies. Source: Seiichiro Noboru, *A Strategy for Enlargement and Outreach* (OECD, 2004), www.oecd.org/globalrelations/globalrelationsstrategy/37434513.pdf



dynamic is starting to change.⁹ Brazil, India, and Indonesia are examples of countries with hybrid public-private regimes.

5. FISCAL REGIMES

Fully private and hybrid public-private regimes allow IOC participation in the E&P of hydrocarbons. States use various legal structures to govern this process and collect rents. The relationship between the IOC and the state is defined in a Central Host Government Contract. This Central Host Government Contract may go by any of many names depending on its characteristics, including “license,” “concession,” “agreement,” and “contract.” Other auxiliary contracts are associated with the upstream and downstream hydrocarbon industry. These may include government contracts with transportation, refining, and trading companies and subcontracts between engineering firms, drilling companies and rig operators. Even states with monopoly regimes utilize these smaller contracts for goods and services. However, states with state monopoly regimes will not have Central Host Government Contracts with IOCs.

States that allow IOC participation in extraction of hydrocarbons may use one of three primary types of Central Host Government Contracts: Production sharing contracts, in which the contractor owns a share of the oil once it is out of the ground; risk service contracts, through which the government owns the oil and the contractor receives a fee for getting the oil; or concessions, through which the contractor owns the oil in the ground.¹⁰

5.1 CONTRACTUAL REGIMES (PRODUCTION SHARING OR RISK SERVICE CONTRACTS WITH IOCS)

Under a contractual fiscal regime, private companies involved in the hydrocarbon sector are treated as contractors. The transfer from the private sector to the government in contractual regimes is written into the contracts, rather than levied with taxes. Contractual regimes may be based on risk service contracts, in which the contracting company pays a fixed fee to the state, or production sharing contracts (sometimes known as production sharing agreements), in which the private company pays the state in the form of a share of production.

9. *Supra* note 5: “National Oil Companies: Evolution, Issues, Outlook.”

10. *Supra* note 4: OpenOil, *Oil Contracts- How to Read and Understand Them*.



5.2 CONCESSIONARY REGIMES (CONCESSIONARY CONTRACTS WITH IOCS)

Under a concessionary regime, the state allows private companies to own hydrocarbon resources in the ground and exploit them independently. States with fully private hydrocarbon regimes usually apply concessionary fiscal regimes. In concessionary regimes, IOCs make transfers to the host government through royalties, corporate income tax and special petroleum taxes.

A royalty is a per-unit tax levied by a government for the right to use resources that are in the public domain. Royalty rates in the oil industry generally range from 5% to 25%. As a per-unit tax, royalties are by definition regressive.¹¹

Corporate income tax is generally applied as a rate of net earnings. Corporate income tax levels vary considerably among countries, but are most often between 25% and 35%. The global average corporate income tax rate is about 24%. In 2013, Mexico's corporate tax rate was 30%. Many countries provide incentives for exploration and production by allowing further tax deductions. The income tax regime in the oil industry is generally the same regime that is applied to all corporate activities in the country, though qualifying deductions often differ.

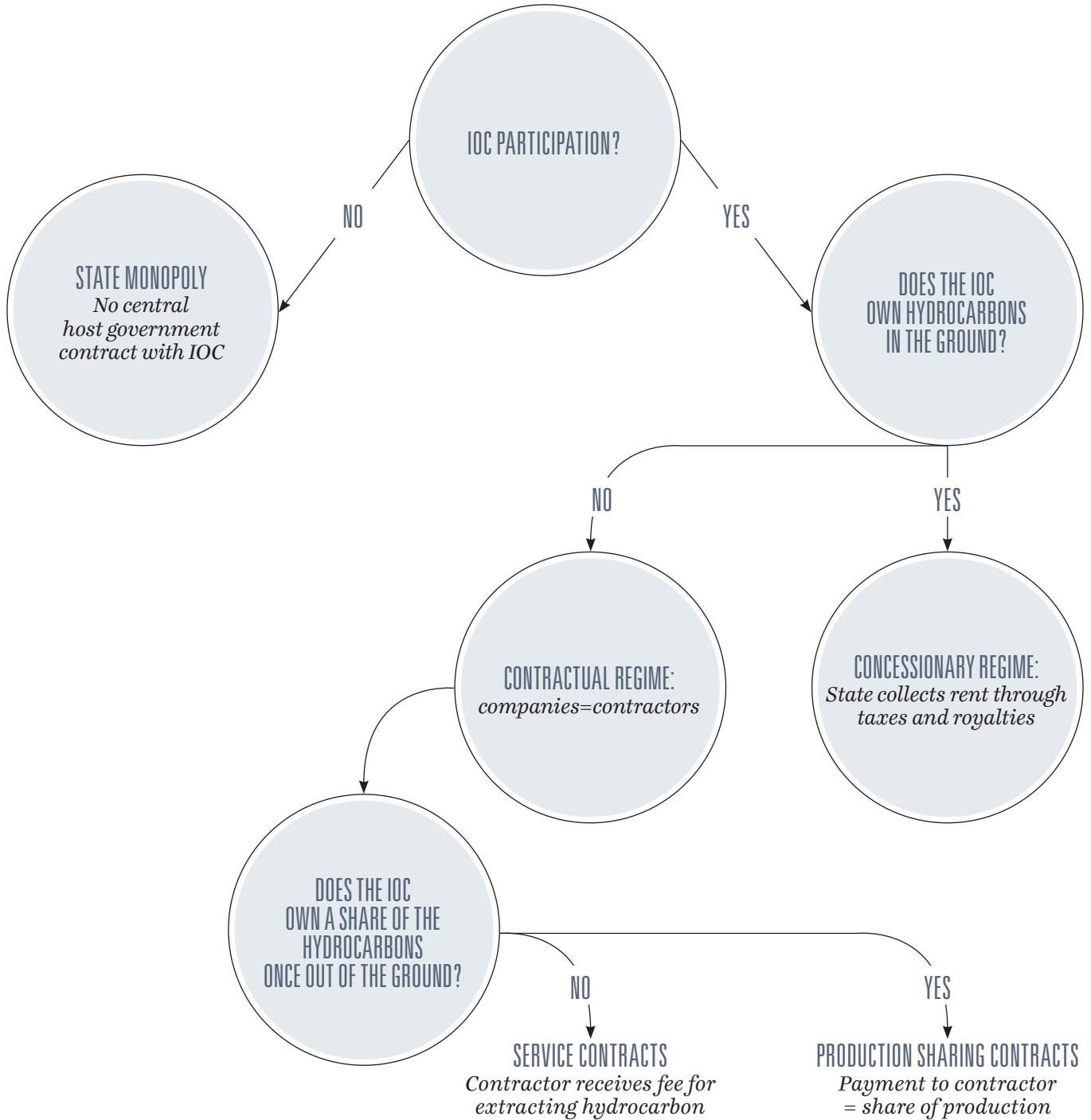
In order to capture more of the economic return from oil production, many countries levy a special petroleum tax. This tax is generally applied on a project or field basis, rather than on aggregate company income. The special petroleum tax is usually based on cash flow and only imposed when cumulative cash flow is positive.¹²

11. A regressive tax is a tax imposed in such a manner that the tax rate decreases as the amount subject to taxation increases. Set royalties are regressive because a project is taxed equally independent of profit levels. Therefore, the lower the profitability of a project, the higher the royalty payment relative to profits. Source: Carole Nakhle, "Petroleum Fiscal Regimes: Evolution and Challenges," in *The Taxation of Petroleum and Minerals: Principles, Problems and Practice* (Routledge, 2010).

12. *Supra* note 1: Nakhle, "Mining and Petroleum Taxation."



SUMMARY: HYDROCARBON FISCAL REGIMES



Source: Nakhle, OpenOil, Author



II. THE MEXICAN HYDROCARBON INDUSTRY

The regulatory framework for Mexico's hydrocarbon industry is currently in flux. Until the most recent energy reform entered into force on December 20th, 2013 (referred to in this document as the 2013 Energy Reform) the Mexican constitution and regulatory framework gave the NOC, Pemex, a monopoly over the extraction, processing, and first hand sale of all hydrocarbons. The system outlined in the 2013 Energy Reform Bill and implemented in the secondary legislation (published in the DOF on August 11, 2014) phases out the state monopoly model and establishes a hybrid public-private contractual regime.

Concessions, a politically charged issue in Mexico, continue to be forbidden under the reform. Licenses and contracts transfer ownership of hydrocarbons at the wellhead, while concessions transfer ownership of resources in the subsoil. Under the new regime, according to Article 27 of the Mexican constitution, all underground hydrocarbon resources will continue to be the property of the Mexican State. Though ideologically important, the contracts will function almost identically to concessions and the fact that licenses and contracts are permitted while concessions are forbidden will not significantly affect financial flows or oversight.¹⁵

PRE-2013 ENERGY REFORM

HYDROCARBON INDUSTRY REGIME:

State Monopoly

FISCAL REGIME:

NA



POST-2013 ENERGY REFORM

HYDROCARBON REGIME:

Hybrid Public-Private

FISCAL REGIME:

Contractual

15. The contracts created by the 2013 reform will allow foreign oil companies to include Mexican crude in calculations of their own reserves, which financial analysts view as a prime indicator of an energy company's health. Though subsoil resources will remain the property of the Mexican State, the estimated value of private contracts can then be converted into barrels and recognized on balance sheets as if they were reserves. In this way, contracts issued by the Mexican Government will allow oil companies to register the economic interest of their exploration and development contracts with the U.S. Securities and Exchange Commission (SEC) without transferring underground ownership of the petroleum.



1. THE 2013 ENERGY REFORM

1.1 PRINCIPLE FEATURES OF THE 2013 ENERGY REFORM

The 2013 Energy Reform Bill changes the Mexican hydrocarbon industry in three broad and basic ways: It allows for privatization, changes oversight mechanisms, and changes the nature and oversight of financial flows.¹⁴

The Energy Reform Bill privatizes the energy industry by reforming Articles 25, 27, and 28 of the Mexican Constitution to allow private companies to participate in the energy sector and incentivize Pemex to operate more like a private sector company. It gives Pemex technical, management and budgetary autonomy. After a one-time “Round Zero” in which Pemex requested and was granted exploration and production rights to fields in which it proved it could profitably produce hydrocarbons, Pemex will have to openly compete for all exploration, production, refinement, petrochemical production, transport, storage and first hand sale licenses and contracts. The bill mandates that Pemex and the Federal Electricity Commission (Comisión Federal de Electricidad, CFE) be converted from decentralized bodies into “productive state enterprises” (*empresas productivas del Estado*).¹⁵ As a productive state enterprise, Pemex is required to become profitable and will operate as a for-profit company thereafter. As a for-profit company, Pemex will have to meet its financial obligations without the help of the federal government. When necessary, Pemex will have to sell off assets to generate operating funds and to pay its employee benefit obligations.

The 2013 Energy Reform attempts to improve Pemex’s internal and external oversight. It removes the representatives of the Mexican Petroleum Workers Union, (el Sindicato de Trabajadores Petroleros de la República Mexicana, STPRM) from Pemex’s board of directors and splits the ten seats evenly between government appointees and independent consultants. It establishes new oversight bodies and gives existing oversight bodies greater autonomy and responsibility. The National Hydrocarbon Commission (Comisión Nacional de Hidrocarburos, CNH) and the Energy Regulatory Commission (Comisión Reguladora de Energía, CRE), existing decentralized agencies of the Ministry

14. Note that the 2013 Energy Reform Bill also affects the Federal Electricity Commission (Comisión Federal de Electricidad, CFE) and the electricity industry. In the electricity sector, the reform opens the CFE to private investment and grants the right of power generation to private citizens. It allows for the creation of a wholesale power generation market with the National Energy Control Center (Centro Nacional de Control de Energía, CENACE) acting as the system operator independently of the CFE.

15. Diario Oficial de la Federación, Decreto por el que se reforman y adicionan diversas disposiciones de la *Constitución Política de los Estados Unidos Mexicanos en Materia de Energía*, 2013, www.dof.gob.mx/nota_detalle.php?codigo=5327463&fecha=20/12/2013. Provisional Article 3, p. 6.



of Energy (Secretaría de Energía, SENER), are given the responsibility of issuing contracts, publishing the terms of contracts, and providing technical regulation for upstream and downstream operations respectively.¹⁶ The bill creates two new regulatory agencies: The National Center for Natural Gas Control (Centro Nacional de Control de Gas Natural, CENEGAS) and the National Agency for Industrial Safety and Environmental Protection in the Hydrocarbon Sector (Agencia Nacional de Seguridad Industrial y de Protección al Medio Ambiente del Sector Hidrocarburos, ANSIPA). CENEGAS will oversee the operation of the national pipeline network currently operated by Pemex and will take over from Pemex all resources, contracts and infrastructure necessary in carrying out this function.¹⁷ ANSIPA will be a decentralized organ of the Ministry of the Environment and Natural Resources (Secretaría del Medio Ambiente y Recursos Naturales, SEMARNAT) and will be responsible for regulating all industrial, operational safety, and environmental matters in the hydrocarbon sector.¹⁸

The reform creates the Mexican Petroleum Fund for Stabilization and Development (Fondo Mexicano del Petróleo para la Estabilización y el Desarrollo, FMPED). The FMPED will be a public trust within the Mexican Central Bank (Banco de México) and will manage all government income for the hydrocarbon industry, with the exception of taxes levied by the Ministry of Finance (Secretaría de Hacienda y Crédito Público, SHCP).¹⁹ The FMPED will have two functions. First, it will be a long-term saving fund inspired by the Norwegian oil fund, the Oljefondet. Additionally, unlike the Oljefondet, it will have oversight capacities: it will be in charge of receiving, administrating and distributing income derived from contracts. Therefore, in the case of a joint venture, either between two IOCs or between Pemex and an IOC, the profits will not be shared directly as defined by the contract (this is what happens in most countries). Instead, the profits will be delivered to the FMPED, which will divide them. This oversight element was added with the intention of increasing contract transparency.

THE PETROLEUM FUND

Annually, assets will be transferred from the FMPED to the national treasury so that total federal income from petroleum, including both tax income and the transfer from the FMPED, equals 4.7% of the previous year's GDP. The remainder of the assets delivered to the fund as well as the financial returns on the investment of those assets will be saved in a long-term savings account. Once the balance of long-term savings account reaches 3% of the previous

16. *Ibid.* Provisional Article 10, p. 12.

17. *Ibid.* Provisional Article 16 a, p. 22.

18. *Ibid.* Provisional Article 19, p. 25.

19. *Ibid.* Provisional Article 14, p. 17.



year's GDP, a percentage of the annual increase in the balance of the account may be transferred to four outside recipients:

- Up to 10% may be transferred to the universal pension system
- Up to 10% may be used to finance the research and development of renewable forms of energy.
- Up to 30% may be transferred to an investment instrument specialized in petroleum projects and infrastructure. This investment instrument will be managed by the Ministry of Energy (SENER).
- Up to 10% may be contributed to university and postgraduate scholarships for human capital development in the hydrocarbon industry.

Once the long-term savings account reaches 10% of GDP, financial returns on the account will be transferred to the national treasury.

1.2 IMPLEMENTATION OF THE 2013 ENERGY REFORM

The Energy Reform Bill set out a number of deadlines for implementing legislation, most over the year following its effective date. Implementation ran slightly behind schedule, but the bill provides no concrete consequences for late legislation. The majority required elements are included in the secondary legislation published in the DOF on August 11, 2014.²⁰

The secondary legislation includes nine new laws and amendments to twelve existing laws.²¹ The legislation is ambitious and covers almost all elements of the 2013 Energy Reform Bill's 21 provisional articles. However, much of the success of the legislation rests on how well it is implemented and the power exercised by the regulatory bodies it creates and empowers.²²

An important element of the transition from a state monopoly regime to a hybrid public-private regime is the initial transfer of rights to oilfields from the state to private companies. At the time of the reform, Pemex operated all oilfields in Mexico. Legislators wanted to ensure that Pemex would be

20. On April 30th, 2014, the last day of the first congressional session on 2014, President Peña Nieto delivered the first round of secondary legislation on energy to the Senate. Both the senate and House of Representatives approved the legislation during extraordinary sessions in July and August and the legislation was published in the Official Gazette (Diario Oficial de la Federación) on August 11th 2014.

21. For a list of new and reformed laws, see Annex I.

22. Information compiled by SENER on the secondary legislation, including links to official copies of the new and reformed laws can be found at www.energia.gob.mx/webSener/leyes_Secundarias/index.html

well positioned to succeed under the new regime while simultaneously transitioning quickly to an open market model. The 2013 Energy Reform tries to achieve this through a one-time Round Zero of bidding in which Pemex selected and was granted exploration and production rights to fields in which it proved it could profitably produce hydrocarbons.

On March 21st 2014, Pemex delivered the list of fields that it wished to maintain. Pemex requested the grant of rights to 83% of proven and probable reserves (known as 2P reserves) and 31% of prospective reserves.²³ SENER, with technical support from CNH, reviewed Pemex's request based on evidence provided by Pemex of its technical, financial, and performance qualifications. Between August 13th and 29th SENER approved nearly 100% of Pemex's request for 2P reserves and 68% of Pemex's request for prospective reserves, or 21% of total prospective reserves. The reserves were transferred to Pemex in the form of 489 allocations, 108 for exploration and 381 for extraction.²⁴

After the completion of Round Zero, 17% of 2P reserves and 79% of probable reserves remain in the hands of the state. In forthcoming rounds of bidding, these fields will be offered to Pemex and national and foreign oil companies. The first round of open bidding began on December 11, 2014. SENER announced that the Round One tender will include 169 exploration and extraction blocks, both onshore and offshore, and predicted that Round One would attract close to \$8,525 million USD in annual investment from 2015 to 2018.²⁵ However, oil prices fell sharply in the 7 months leading up to Round One.²⁶ This lowers the incentive for investment in expensive-to-drill fields. Energy Minister, Luis Videgaray, told the Mexican radio station XEU that bidding on non-conventional onshore fields, primarily consisting of shale fields, may be postponed.²⁷

23. "SOLICITUD DE Pemex," *Comisión Nacional de Hidrocarburos*, accessed April 3, 2014, www.energia.gob.mx/webSener/rondacero/9214.html

24. Information compiled by SENER and the CNH on Round Zero can be found at www.energia.gob.mx/webSener/rondacero/index.html

25. Information compiled by SENER on Round One can be found at www.energia.gob.mx/webSener/rondauno. Further information on Round One compiled by CNH with support from SENER and SHCP can be found at www.ronda1.gob.mx/seguimiento.html.

26. The price of oil fell by more than 40% between June and December 2014.

27. "Ronda Uno podría aplazarse por baja en precio del petróleo: Videgaray," *XEU*, January 15, 2015, www.xeu.com.mx/nota.cfm?id=683519.



2. GOVERNMENT OVERSIGHT OF THE HYDROCARBON SECTOR

UPSTREAM VS. DOWNSTREAM HYDROCARBON INDUSTRY

Oversight is a crucial element of an analysis of financial flows, both legal and illicit. Inefficient or incomplete oversight frameworks can act as an implicit financial flow from the state to the hydrocarbon sector. Even in the case of well laid out oversight mechanisms, the failure by oversight bodies to carry out legally mandated roles is an implicit financial flow from the state to the hydrocarbon sector. Additionally, failure to carry out oversight can be a red flag for illicit financial flows from the hydrocarbon sector to the state or representatives of the state.

EXAMPLE 1:

Complying with a certain environmental norm costs a private drilling company \$10,000. If the environmental norm is not enforced, though no money changes hands, there is an implicit transfer of \$10,000 from the state to the private drilling company caused by lack of oversight mechanisms.

EXAMPLE 2:

An oversight mechanism for the environmental norm exists, but the drilling company chooses to bribe state functionaries in charge of overseeing compliance \$1,000 rather than spending ten times that to comply with it. Here, failure to carry out oversight is a red flag for an illicit financial flow.

The first line of oversight of the Mexican hydrocarbon industry is Pemex's own internal oversight structures. Prior to the 2013 Energy Reform, external government agencies set national energy policy, provide technical and administrative oversight and environmental, labor, and industrial safety oversight of both Pemex and private sector actors, as well as budgetary oversight of Pemex. Additionally, Pemex was subject to government-wide public procurement and anti-corruption oversight and transparency mechanisms. With the implementation of the 2013 Energy Reform, government budgetary and public procurement oversight of Pemex are removed.

The government entities involved, the specific powers and responsibilities they hold, and the ways in which the 2013 Energy Reform will affect the framework are discussed below.

2.1 PEMEX INTERNAL OVERSIGHT

The first layer of oversight of Pemex is its Board of Directors (Consejo de Administración). Between the 2008 Energy Reform and the 2013 Energy Reform, Pemex's board of directors was made up of 15 members including five representatives of the SNTPRM, six state representatives appointed by the executive branch, and four professional board members including an external



auditor.²⁸ In recent years the six state representatives have been limited to representatives from the SHCP, SENER and the Ministry of the Economy (Secretaría de Economía, SE).²⁹ In the past, the Minister of Environment was included on the board of Pemex.

The 2008 Energy Reform added professional board members in order to provide technical knowledge and strengthen decision-making capacity. When the advisors were chosen, stakeholders believed that their appointment was based on political interests. However, the professional members have proven successful in functioning as a counterweight mechanism within the board.³⁰

With the implementation of the 2013 Energy Reform, the Pemex Board of Directors consists of five state advisors, including the Ministries of Energy and Finance, and five independent advisors. The Minister of Energy is the chair.³¹

The 2008 reform created two internal oversight committees that monitor Pemex's board of directors, the Transparency and Accountability Committee and Performance Assessment Committee. Additionally, it created a special commissioner to report on accuracy, sufficiency and reasonableness of information provided by the company.³² However, it is unclear that these internal mechanisms have contributed significantly to increasing productivity or decreasing corruption since their creation.

Once converted into a productive state enterprise, as laid out by the 2013 Energy Reform, Pemex will have technical, management and budgetary autonomy. Note that it will still be subject to the federal debt ceiling and salary ceilings. Its internal governing bodies will determine the organization, administration, and corporate structure of the company in accordance with "international best practices."³³ Pemex will have the right to change existing and implement new internal oversight mechanisms.

28. "Board of Directors," *Pemex Investor Relations*, accessed July 22, 2014, www.ri.Pemex.com/index.cfm?action=content§ionID=18&catID=12163.

29. Specifically, the Minister of Energy, who chairs the board, the Minister of the Economy, Undersecretary of Hydrocarbons of the Ministry of Energy, the Undersecretary of Planning and Energy Transition of the Ministry of Energy, and the Undersecretary of Revenue of the Ministry of Finance and Public Credit.

30. Rocio Moreno, "Mexico: A Moment of Opportunity" (Revenue Watch Institute, 2012), www.transparency-initiative.org/wp-content/uploads/2012/12/TAIMexico1.pdf.

Hereinafter: Moreno, "Mexico: A Moment of Opportunity."

31. Diario Oficial de la Federación, Reforma Energetica. Provisional Article 20 IV, p. 27.

32. *Supra* note 30: Moreno, "Mexico: A Moment of Opportunity."

33. Diario Oficial de la Federación, Reforma Energetica. Provisional Act 20 III, p. 27.



2.2 POLICY DIRECTION AND TECHNICAL AND ADMINISTRATIVE OVERSIGHT

SENER, with technical support from its decentralized agencies the CNH and CRE, is responsible for setting energy policy and regulating the hydrocarbon industry, including both Pemex and private sector actors. Although SENER is defined as the sole ministry responsible for setting energy policy, in reality the SHCP has played a key role as well because Mexican public finances depend heavily on oil revenues. Conversely, the Ministry of Social Development (Secretaría de Desarrollo Social, SEDESOL) according to its mandate should have input on policy formation, but in reality has little power over the industry.

SENER, together with the CNH and CRE, provides technical and administrative oversight of the upstream and downstream hydrocarbon industry respectively. Prior to the implementation of the 2013 Energy Reform, this consisted primarily of overseeing Pemex. With the 2013 Energy Reform, the CNH and CRE's responsibilities will be broadened and their jurisdiction extended further into the private sector.

Prior to the implementation of the 2013 Energy Reform, SENER's specific responsibilities regarding the hydrocarbon industry included:⁵⁴

- Setting national energy policy, including establishing the production and replacement rates for Pemex.
- Issuing permits for survey and surface exploration to Pemex.
- Granting, denying, modifying, revoking and, if necessary, canceling allocations for E&P of hydrocarbons (*asignaciones petroleras*) to Pemex.
- Supervising the compliance of Pemex with survey and surface exploration permits and E&P allocations.
- Regulating industrial security in the hydrocarbon sector.
- Establishing end-phase (*restitución*) policy and supervising its compliance.
- Regulating, supervising and overseeing private sector participation in the natural gas and electricity sectors and basic petrochemical transport, storage and first-hand sale.
- Regulating and supervising Pemex in oil refinement and basic petrochemical production.
- Regulating and supervising Pemex in the transport, storage, and first-hand sale of refined petroleum products.

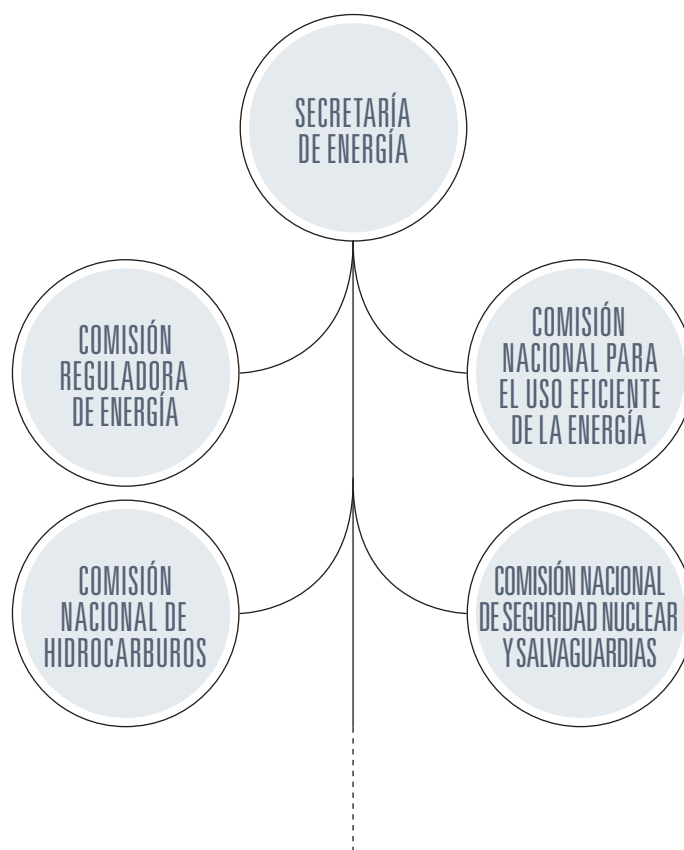
54. Josefina Cortés Campos, *La Comisión Nacional de Hidrocarburos y el Debate de las Autonomías ¿Necesarias?* (Mexico: Centro de Investigación para el Desarrollo, A.C., 2013), reddecompetencia.cidac.org/es/uploads/1/5RegWeb_CNH1708.pdf. Hereinafter: Cortés Campos, *La CNH*.



Additionally, SENER was in charge of collecting and making public information on the energy industry.³⁵ Together with the CNH, it operated the National Hydrocarbon Information System (Sistema Nacional de Información de Hidrocarburos). Within the system, SENER managed the Petroleum Cadastre³⁶ and the Hydrocarbon Reserve Register, while CNH ran the Petroleum Register and the Geological Information Register.

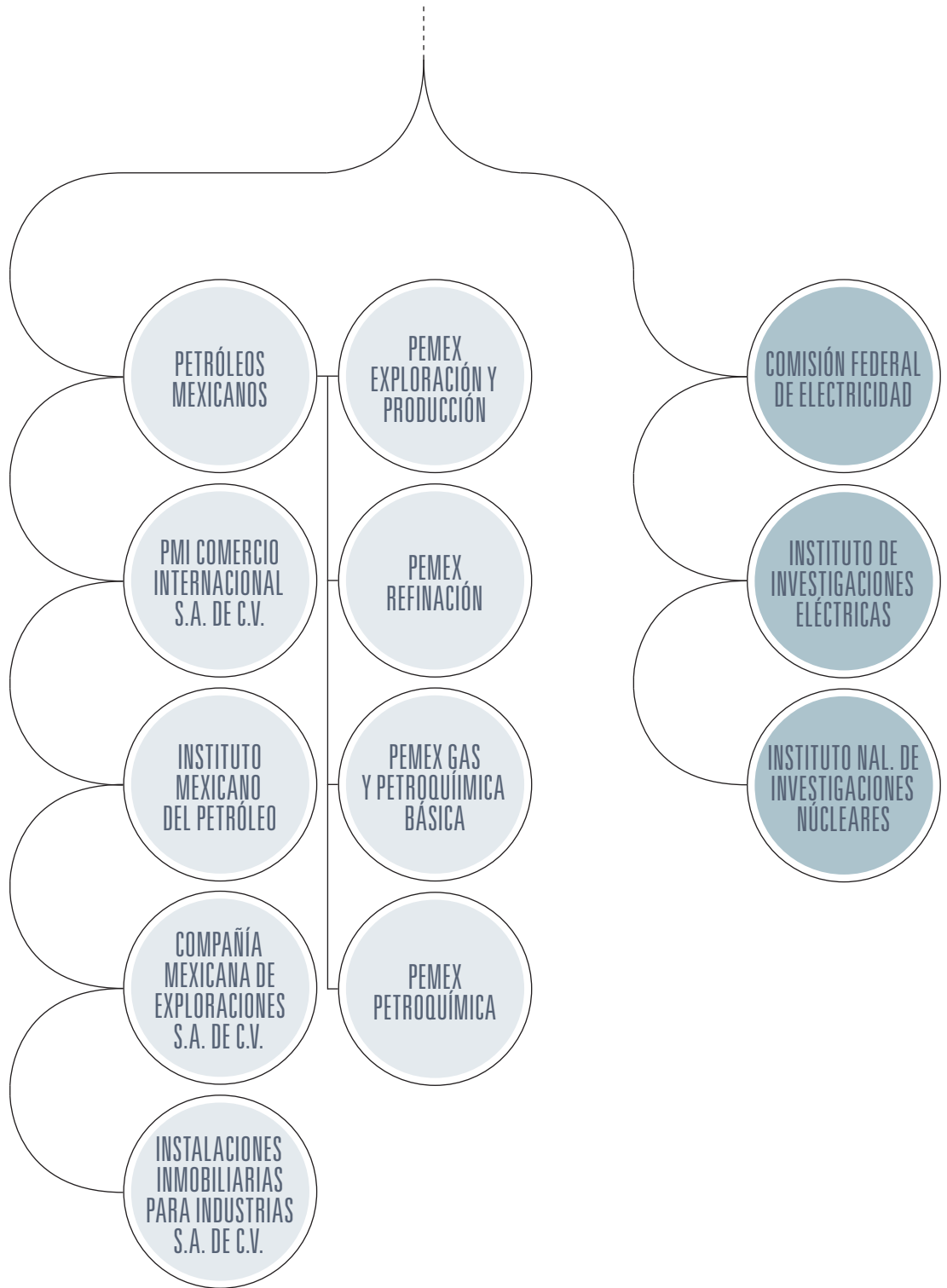
THE OVERSIGHT STRUCTURE OF SENER AND STATE ENERGY SECTOR (PRIOR TO THE 2013 ENERGY REFORM)

CENTRAL SECTOR



35. In conformity with the Federal Law of Transparency and Access to Public Government Information (Ley Federal de Transparencia y Acceso a Información Pública Gubernamental).

36. A public register showing the details of ownership and value of land.



Source: SENER Website



The CNH and CRE are decentralized agencies of the Ministry of Energy. The CNH was created in 2008 and has technical and operational autonomy. Under the pre-reform framework, the CNH was a technical advisory body to SENER for upstream energy operations. It worked with SENER, the Ministry of Labor (Secretaría del Trabajo y Previsión Social, STPS) and the SEMARNAT to provide technical support in the creation of energy policy, administration of resources, health and security regulation, and environmental regulation. Prior to the implementation of the 2013 Energy Reform, the CNH's specific responsibilities included:⁵⁷

- Providing technical advice (*dictamen técnico*) to SENER. This advice could relate to permits for survey and surface exploration, E&P allocations, or industrial safety.
 - However, CNH's technical advice was non-binding.
- Visiting sites and verifying compliance, on the part or at the request of SENER.
- Evaluating operational efficiency of hydrocarbon exploration and production.
 - However, the law did not make clear the consequence of a negative evaluation.
- Sanctioning Pemex for illicit conduct.
 - In theory, in the case of non-compliance with norms (for gas flaring and venting, failure of compliance with safety measures in deep water, and failure in hydrocarbon measurement) CNH could fine Pemex and its subsidiaries between 1,000 and 1,000,000 times the current minimum wage.
 - However, CNH lacked the infrastructure and mechanisms to effectively carry out sanctions.⁵⁸

Whereas the CNH assists SENER in the regulation and oversight of the upstream hydrocarbon industry, the CRE assists SENER in the regulation and oversight on the downstream hydrocarbon industry. The CRE entered into existence by presidential decree in 1994 and by law in 1995. It was originally created to advise SENER on its interaction with the CFE. Later, the CRE's oversight was extended to the refinement, transport, storage and first-hand sale of basic petrochemicals and the extraction, importation, transport, storage and first-hand sales of natural gas and gas L.P. The CRE also oversees the production and incorporation into the electric grid of renewable energies. Prior to the implementation of the 2013 Energy Reform, the CRE's specific responsibilities regarding the hydrocarbon industry included:⁵⁹

37. *Supra* note 32: Cortés Campos, *La CNH*.

38. Alejandra López, "Falta a la CNH sancionar a Pemex," *Reforma*, February 27, 2012, sec. Negocios.

39. José María Lujambio Irazábal, *La Comisión Reguladora de Energía en las Reformas Energéticas de 2008 y 2013* (Mexico: Centro de Investigación para el Desarrollo, A.C., 2013), reddecompetencia.cidac.org/es/uploads/1/5/Reg_CRE2608.pdf.



- Providing technical advice to SENER.
- The electricity and natural gas sectors and petrochemical transport by pipeline were open to private investment prior to 2013.⁴⁰ Therefore, unlike the CNH, the CRE role included issuing permits to Pemex as well as private sector actors. The CRE issued permits for the extraction, storage and transport of natural gas and gas L.P., the transport of petrochemicals by pipeline, and the production of electricity over 5 mw.
- Overseeing first-hand sales of natural gas, gas L.P. and basic petrochemicals. Specifically, the CRE set the terms and conditions of contracts and established the methodology of pricing for the new hydrocarbon products under its regulation.
- Sanctioning Pemex and private sector companies for illicit conduct.
- Like the CNH, the CRE could fine Pemex and private companies between 1,000 and 1,000,000 times the current minimum wage.
- The CRE could order security measures in operations it oversees (equipment, pipelines, etc.) that present grave danger to people or property.⁴¹
- The CRE was limited in its ability to sanction, but proved to be a more effective sanctioning body than the CNH.

The Energy Regulators Act (la Ley de los Órganos Reguladores Coordinados en Materia Energética), one of the elements of the secondary legislation published August 11, 2014, strengthened the CNH and CRE. The act conferred new legal powers on the agencies and restructured them. Additionally, it created the Energy Sector Coordinating Council (Consejo de Coordinación del Sector Energético), made up of the Secretary of Energy, his/her three undersecretaries, and the directors of CENEGAS and the National Energy Control Center (Centro Nacional de Control de Energía).

With the implementation the 2013 Energy Reform, SENER, with the assistance of the CNH, is responsible for defining areas for upstream oil contracts. The SHCP is responsible for setting the contract's financial terms. During Round Zero SENER accepted or denied the fields requested by Pemex. As the reform implementation moves forward and open bidding rounds commence, SENER will be responsible for specifying the surface area, depth, and term of each field available for licensing or contracting and for providing the technical and contractual conditions.⁴² With the implementation of the 2013 Energy Reform, SENER's specific responsibilities are expanded to include:

40. The electricity sector has been open to private investment since the 1992 reform of the Ley del Servicio Público de Energía Eléctrica, and the natural gas sector has been open to private investment since the 1995 Reforma Energética.

41. The first time the CRE used this faculty was in May 2013 (RES/184/2013), when the CRE closed a network of LP gas distribution ducts in Lomas Verdes in Naucalpan, Estado de Mexico.

42. Diario Oficial de la Federación, *Reforma Energetica*. Provisional Article 20 IV, p. 27.



UPSTREAM:

- Defining areas to lease for hydrocarbon E&P.
- Issuing and revoking leases.
- Deciding on the applicable type of contract.
- Designing the framework for contracts and tender terms, including prequalification and award mechanisms.

DOWNSTREAM:

- Issuing permits for oil refining and natural gas treatment.
- Setting public policy on petroleum supply and storage.

The SHCP's specific responsibilities regarding the hydrocarbon industry are expanded to include:

- Determining fiscal terms of contracts and tenders.
- Establishing financial criteria for awarding contracts.
- Overseeing Pemex and private companies' accounting.

With the implementation of the 2013 Energy Reform, the CNH and CRE are responsible for carrying out the tender process, administering the contracts and licenses, publishing the terms of the agreements, and ensuring that the payments are made to the FMPED for upstream and downstream operations respectively.⁴³ For the CNH, this represents an extremely significant new responsibility. Prior to the 2013 reform, the CNH assisted SENER in the allocation of E&P rights to Pemex, but had not overseen the private sector and never conducted competitive bidding. In order to carry out these responsibilities, the CNH's responsibilities are expanded to include:

- Carrying out the tender process and signing contracts for hydrocarbons exploration and extraction.
- Regulating and supervising the survey, exploration, and extraction of hydrocarbons; including oversight of the process from collection from the points of production through integration to the transportation and storage system.
 - Authorizing seismic studies, exploration for non-conventional wells, and drilling.
 - Approving and providing technical supervision of exploration and production plans.

The change for CRE will be less dramatic, as the commission already has experience overseeing private sector bid-tenders. However, the CRE must broaden its oversight powers and expertise regarding the hydrocarbon industry, as oil refineries and basic petrochemical production will be open to

43. *Ibid.* Provisional Article 10, p. 12.



private investment for the first time. The CRE's responsibilities will continue to include issuing permits for commercialization, transport and distribution of hydrocarbons. Its responsibilities are expanded to include:

- Issuing permits for the final sale of petroleum.
- Regulation of First Hand Sales.
- Regulating access to transportation infrastructure and storage.

The newly created CENEGAS will be responsible for the management, administration, and operation of the national transportation pipelines system and hydrocarbon storage infrastructure, including carrying out the tender process for associated contracts.

For the reform to be successful, the CNH, CRE and CENEGAS will have to operate as extremely proficient and powerful oversight bodies. Implementing legislation has created the legal framework for technical oversight in the newly open upstream and downstream hydrocarbon industry. However, the agencies will have to prove their ability to mobilize their new powers over the coming years.

2.3 ENVIRONMENTAL, LABOR, AND INDUSTRIAL SAFETY OVERSIGHT

Prior to the implementation of the 2013 Energy Reform, SEMARNAT, the Federal Environmental Protection Attorney (Procuraduría Federal de Protección al Ambiente, PROFEPA), and the Ministry of Employment and Social Security (Secretaría del Trabajo y Provisión Social, STPS) were the primary government bodies responsible for environmental, labor, and industrial safety regulation and oversight of the hydrocarbon industry. The CNH, CRE, and state level Attorneys for Environmental Protection (Procuraduría Estatal del Medio Ambiente) also had oversight powers. The Navy (Secretaría de la Marina) and National Water Commission (Comisión Nacional del Agua) had oversight regarding underwater drilling and water contamination related to oil spills. With the implementation of the 2013 Energy Reform, the majority of the oversight responsibility is transferred to the newly created ANSIPA. However, these other oversight bodies will likely maintain certain powers.

Prior to the 2013 Energy Reform, environmental oversight of the hydrocarbon industry fell primarily in the hands of SEMARNAT, specifically the Commission on Energy and Extractive Activities (Dirección General de Energía y Actividades Extractivas) and the Commission on Environmental Impact and Risk (Dirección General de Riesgo e Impacto Ambiental). SEMARNAT is mandated to monitor private and public companies' compliance with environmental standards.



However, SEMARNAT is not empowered to sanction private or public actors who fail to comply with environmental regulation. Instead, the role of sanctioning falls to PROFEPA. PROFEPA has the power to fine guilty parties, order the closure of facilities, and demand other actions, such as environmental cleanup after an oil spill. SEMARNAT may request sanctions from PROFEPA. PROFEPA has its own industrial inspection policy (though there is little clarity about exactly what it consists of or what its budget is), and any individual or company may submit environmental complaints to PROFEPA.

STPS was responsible for monitoring labor conditions. The CNH and CRE also have some labor oversight powers, as they may order security measures in operations that present grave danger to people or property. The STPS's oversight focuses on less technical safety matters, labor conditions, and hygiene. The STPS is empowered to investigate complaints made by workers and may sanction offending parties.⁴⁴ However despite these powers, it has done little to promote labor rights in the extractive industry.

Though the abovementioned government agencies have oversight powers, the majority of the monitoring of environmental impact and industrial security of Pemex was performed internally. El Sistema para la Administración de Seguridad, Salud y Protección Ambiental (Pemex-SSPA), initiated in 2006, managed environmental protection and industrial security within Pemex. Pemex-SSPA reported on and analyzed environmental impact and industrial security incidents. Additionally, it provided training for Pemex workers on environmental protection and industrial security. However it could not effectively oversee compliance because it was an internal system and had no power to sanction.⁴⁵ Additionally, in 2008 SENER, STPS, and Pemex signed the Programa de Autogestión en Seguridad y Salud en el Trabajo. Under the agreement, Pemex, rather than STPS, realizes security inspections of its own facilities.^{46,47}

The 2013 Energy Reform created ANSIPA, a decentralized organ of the SEMARNAT with technical and management autonomy. ANSIPA is responsible for regulating industrial, operational safety, and environmental matters in the hydrocarbon sector and is empowered to investigate incidents and accidents

44. Diario Oficial de la Federación, *Reglamento General de Inspección Del Trabajo Y Aplicación de Sanciones*, 2014, dof.gob.mx/nota_detalle.php?codigo=5348879&fecha=17/06/2014.

45. Pemex, "Memoria de Labores 2012," 2013, www.pemex.com/acerca/informes_publicaciones/Documents/memorria-labores_2012.pdf.

46. "Pemex, SENER y STPS Suscriben Acuerdo de Colaboración y Convenio para Fortalecer la Seguridad en las Instalaciones Petroleras," *Presidencia de La República*, July 31, 2008, calderon.presidencia.gob.mx/2008/07/Pemex-sener-y-stps-suscriben-acuerdo-de-colaboracion-y-convenio-para-fortalecer-la-seguridad-en-las-instalaciones-petroleras.

47. Ramón Sevilla, "Desde 2008, Pemex Hace Sus Inspecciones: STPS," *24 Horas*, February 12, 2013, www.24-horas.mx/desde-2008-Pemex-hace-sus-inspecciones-stps.



and impose penalties and mandatory security measures. The President freely appoints its head. It is unclear to what extent Pemex monitoring will continue to be executed internally and which if any oversight responsibilities will remain in the hands of other agencies.

2.4 BUDGETARY OVERSIGHT OF PEMEX

Prior to the 2013 Energy Reform Pemex's annual budget was incorporated into the consolidated annual budget of the Mexican Government, which is presented by the SHCP for approval by the Mexican Congress. Prior to the 2008 Energy Reform, Pemex was required to present a 5-year financial program to the SHCP and Congress for approval as well. Additionally, prior to 2008 Pemex did not have autonomous debt management. Its investment expenses were included on the public sector balance sheet and SHCP approval was required to list bonds.

The 2008 energy reform started to move Pemex in the direction of budgetary autonomy. It included a 7-year budgetary autonomy plan that would eventually allow Pemex to use its own excess income and approve adjustments to its budget without prior authorization from the SHCP. It gave Pemex a more flexible investment ceiling tied to Pemex's resource availability rather than Mexico's treasury and allowed Pemex to list bonds without SHCP approval.⁴⁸

The process of budgetary autonomy was completed under the 2013 Energy Reform, which specifies that Pemex will be transformed into a productive state enterprise. As part of this process, Pemex is granted budgetary autonomy. It has full control over the allocation of any budgetary surplus and has the right to independently define its investment and operations budget. Additionally, Pemex is permitted to freely decide its financing strategy, including determining the instruments and markets in which it will trade, without SHCP approval. However, the Pemex budget will continue to be subject to the federal debt ceiling authorized by Congress and certain salary caps.

2.5 PUBLIC PROCUREMENT OVERSIGHT

Prior to the 2013 Energy Reform, Pemex had its own public procurement process and contract protest mechanisms governed by Ley de Petroleos Mexicanos. However, Pemex was also required to function within the regulatory framework for federal public procurement laid out in the Ley de

48. Only under "exceptional circumstances" can SHCP suspend Pemex bond listings.

Adquisiciones, Arrendamientos y Servicios del Sector Público and the Ley de Obras Públicas y Servicios Relacionados con las Mismas. Therefore, though Pemex’s public procurement process was separate and was governed by a different law, it was almost identical to the federal process.

The SHCP is responsible for interpreting laws and establishing policy regarding federal public procurement. The federal public procurement process starts with a public bid announcement.⁴⁹ Next, there must be at least one clarification meeting. The terms of the bid may be changed in the clarification meeting and are not final until all clarification meetings are complete. Next, bids are presented and evaluated. Finally, the contract is awarded to the winning bid and signed. There are minimum timeframes for each step, and on average the whole process takes six to seven weeks. The contract must be awarded to the firm that complies with all the requirements of the bid at the lowest price. A firm may contest the government’s decision. However only about 5% of government contracts are contested due to the high cost of lawyers, lack of confidence in the mechanisms, and reluctance to alienate government contractors in the hopes of winning future contracts.

Under special circumstances, the bid process may be circumvented and contracts may be awarded directly (*adjudicaciones directas*). These include cases in which: there is only one bid, for example technologies with copyrights; there are national security concerns; the project is time sensitive; the project is brand sensitive; the project involves consulting services in which relationships or personality are important; or in the case of “contractos marcos” in which there is a list of pre-approved vendors for a standardized service, such as plane tickets or event catering.

The bid process is operated through Compranet (www.compranet.gob.mx). Compranet is a free, digital, searchable database of public contracts operated by the Ministry of Public Administration (Secretaría de Función Pública, SFP). All federal contracts, including those issued by Pemex and its subsidiaries, and some state contracts are published through the platform.⁵⁰ Within Compranet, the tender process is 100% digitized. In order to respond to a government bid announcement, a bidding company must upload its bid to the Compranet system. This limits opportunity for corruption and is in line with international best practices. The bid announcement, all company bids, and information on which bid was chosen, how much the company will be paid, which bids were disqualified, and why, are available through the site. Additionally, directly awarded contracts and the justification for their direct award are published.

49. In special cases there may also be a pre-bidding phase.

50. Use of Compranet is not obligatory on the state level. States may choose to publish all, some, or none of their public contracts through the platform.



With the implementation of the 2013 Energy Reform the structure of public procurement oversight for Pemex changed. The Ley de Adquisiciones, Arrendamientos y Servicios del Sector Público and the Ley de Obras Públicas y Servicios Relacionados con las Mismas are no longer applicable to Pemex.⁵¹ Instead the process will be fully governed by the Board of Directors of Pemex. The reform created a Committee on Acquisitions, Leasing, Works and Services (El Comité de Adquisiciones, Arrendamientos, Obras y Servicios) under the Pemex Board of Directors that will oversee the process.⁵² The change is designed to bring Pemex's oversight in line with that of private companies. It is unclear if Pemex's contracting system will continue to be operated through Compranet or through a new system.

2.6 TRANSPARENCY AND ANTI-CORRUPTION MECHANISMS

The Mexican government-wide anti-corruption and transparency mechanisms extend to Pemex and are an important element of industry oversight. The National Transparency, Access to Information and Protection of Personal Data Institute (Instituto Nacional de Transparencia, Acceso a la Información, y Protección de Datos Personales, INAI) is the central government-wide transparency mechanism. The National Anti-Corruption System (Systema Nacional de Anti-Corrupción, SNA) was created on paper with the passage of the 2015 anti-corruption reform to prevent, detect and sanction acts of corruption and those responsible.

2.6.1 TRANSPARENCY MECHANISMS

The INAI, (formerly the IFAI) was established in 2003 as an autonomous oversight body to ensure policy transparency and the right to access information established in the 2002 Federal Law on Transparency and Access to Public Government Information (Ley Federal de Transparencia y Acceso a la Información Pública Gubernamental).⁵³ The Federal Law on Transparency applies to all federal government entities.⁵⁴ The same legislative and institutional framework was set up in each state and applies to all state

51. H. Congreso de la Unión. *Decreto por el que se expiden la Ley de Petróleos Mexicanos y la Ley de La Comisión Federal De Electricidad, y se Reforman y Derogan diversas disposiciones de la Ley Federal de Las Entidades Paraestatales; la Ley De Adquisiciones, Arrendamientos y Servicios del Sector Público y la Ley de Obras Públicas y servicios relacionados con las mismas*, 2014, www.dof.gob.mx/nota_detalle.php?codigo=5355990&fecha=11/08/2014. Article 75.

52. *Ibid.*

53. Diario Oficial de la Federación, *Ley Federal de Transparencia y Acceso a la Información Pública*, 2002, www.diputados.gob.mx/LeyesBiblio/pdf/244.pdf.

54. Specifically, the federal executive, legislative and judicial branches, autonomous constitutional organs, administrative tribunals and any other federal organ.



government entities. In 2007, the right to information was institutionalized as a fundamental right in Article 6 of the Mexican Constitution. The 2014 Transparency Reform extended the jurisdiction of INAI (and other transparency mechanisms such as the ASF) to political parties and unions that receive public resources.⁵⁵ Through INAI, any individual may request information on the entities over which the institute has jurisdiction. Information is requested through an online platform (www.infomex.org.mx) managed by INAI. Each government agency as well as each subsidiary of Pemex has an information committee (Comité de Información) charged with responding to INAI information requests. Additionally, INAI runs the Transparency Obligations Portal (Portal de Obligaciones de Transparencia), an online, searchable portal that aggregates a large amount of public government information (portaltransparencia.gob.mx). Article 83 of the Federal Law on Transparency requires Pemex to comply with the maximum standard of transparency regarding its contracts, allocations, permits and business relationships.⁵⁶

2.6.2 THE ANTI-CORRUPTION MECHANISMS

The anti-corruption framework in the Mexican government is undergoing a still-incomplete reform. The National Anti-Corruption System (Sistema Nacional de Anti-Corrupción, SNA) centers on an Anti-Corruption Coordinating Committee comprised of the heads of five government entities: the Auditoria Superior de la Federación (ASF), the Fiscalía Especializada en Combate a la Corrupción, the Secretaría de la Función Pública (SFP), the Tribunal Federal de la Justicia Administrativa, and the INAI. The committee is also supposed to include a representative from a Citizen Participation Committee (Comité de Participación Ciudadana) and the Federal Judicial Council (Consejo de la Judicatura Federal).⁵⁷

Prior to the reform and until its implementation takes effect, three offices have been in charge of monitoring and prosecuting corruption within the federal government: the SFP; the Anti-Corruption Prosecutor's Office (Fiscalía Especializada en Materia de Delitos Relacionados con Hechos de Corrupción), and the ASF. Because the system has been highly decentralized

55. Diario Oficial de La Federación, *Decreto por el que se Reforman y Adicionan Diversas Disposiciones de la Constitución Política de los Estados Unidos Mexicanos en Materia de Energía*, December 2013, dof.gob.mx/nota_detalle.php?codigo=5327463&fecha=20/12/2013.

56. Diario Oficial de la Federación. *Decreto por el que se expide la Ley General de Transparencia y Acceso a la Información Pública*. May 4, 2015. www.dof.gob.mx/nota_detalle.php?codigo=5391143&fecha=04/05/2015.

57. Diario Oficial de la Federación. *Decreto por el que se expide la Ley General de Transparencia y Acceso a la Información Pública*. May 27, 2015. www.dof.gob.mx/nota_detalle.php?codigo=5394003&fecha=27/05/2015.



and in flux for many years, to date Mexico's anti-corruption system has been extremely ineffective. The new law may change that by expanding the power and authority of the ASF and the SFP, as well as requiring imposition of sanctions not only against public servants but also against companies found to be involved in corruption. That said, the details are still pending (secondary legislation is due to be adopted throughout 2015 and 2016). As such, it remains to be seen if the SNA will close the current oversight gaps in Mexico's anti-corruption system.

3. OFFICIAL FINANCIAL FLOWS IN THE HYDROCARBON SECTOR

The primary official financial flows in the hydrocarbon industry are taxes, debt, and contract payments. Until the privatization of the hydrocarbon industry with the implementation of the 2013 Energy Reform, Pemex had been an important actor in almost all financial flows in the Mexican hydrocarbon industry. Private sector companies were permitted to enter into limited types of contracts with Pemex and paid normal corporate income tax. With the 2013 Energy Reform, flows between Pemex and the government and private sector companies and the government will be more similar, and a broader range of contracts, including joint ventures, are now permitted between Pemex and private sector companies.

3.1 TAXES

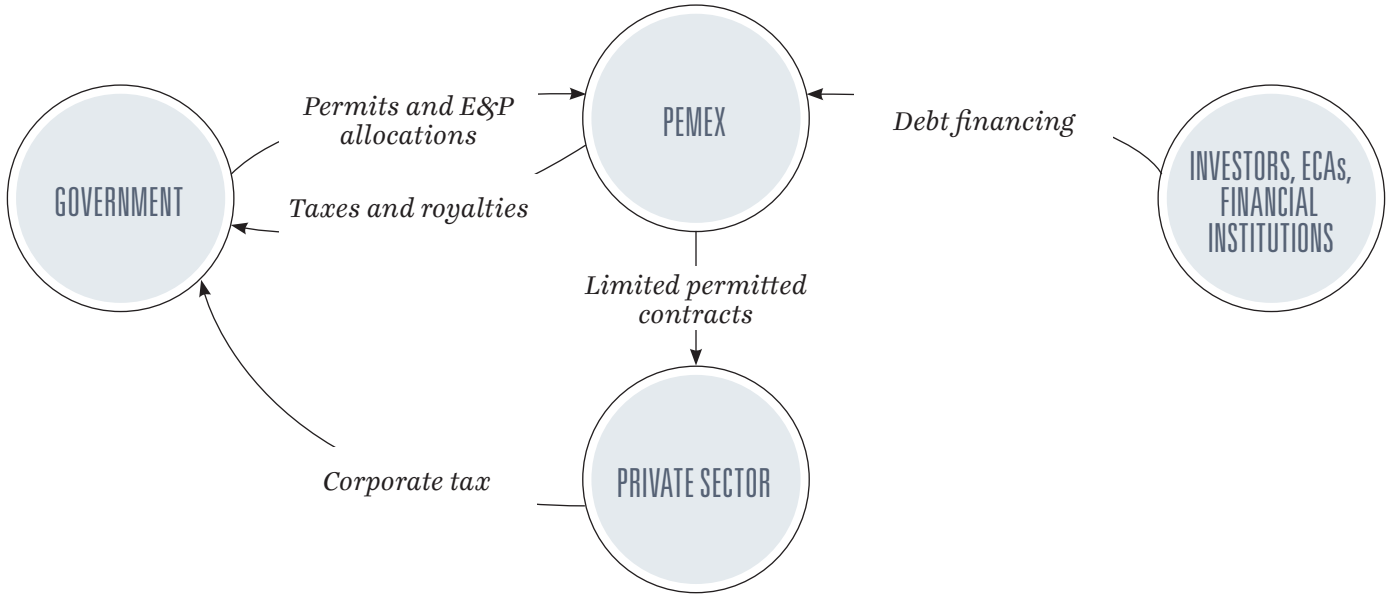
Mexico's public finances have depended heavily on oil-related revenues for the past two decades. Over the decade leading up to the 2013 Energy Reform, oil-related revenues were on average 35.3% of total government revenues.⁵⁸ For full information on Mexico's public sector budgetary revenue see Annex II.

Mexico's non-oil related tax revenues are very low compared to those of other developed countries. This is partially attributable to widespread tax evasion motivated by perceived corruption and a large informal economy. However, tax rates are much lower than those of other developed countries as well. In 2012, Mexico had the lowest tax burden to GDP ratio of any OECD country: 19.6% to the OECD average of 34.6%.⁵⁹ In 2013 the Mexican Congress approved a number of tax amendments to go into effect in 2014 aimed at increasing non-oil tax

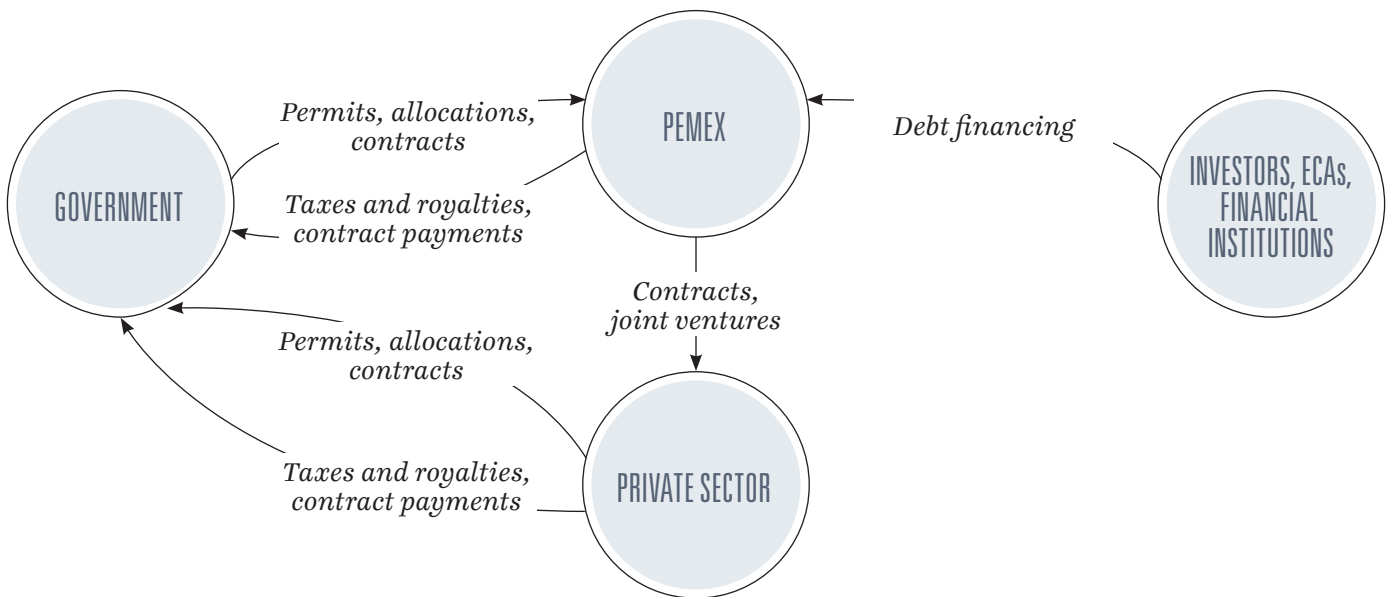
58. "Finanzas Públicas," *Secretaría de Hacienda y Crédito Público*, accessed March 21, 2014, www.hacienda.gob.mx/POLITICAFINANCIERA/FINANZASPUBLICAS/Estadisticas_Oportunas_Finanzas_Publicas/Informacion_mensual/Paginas/finanzas_publicas.aspx

59. OECD, "Tax Revenues Continue to Rise across the OECD," accessed March 24, 2014, www.oecd.org/newsroom/tax-revenues-continue-to-rise-across-the-oecd.htm

PRE-REFORM OFFICIAL FINANCIAL FLOWS

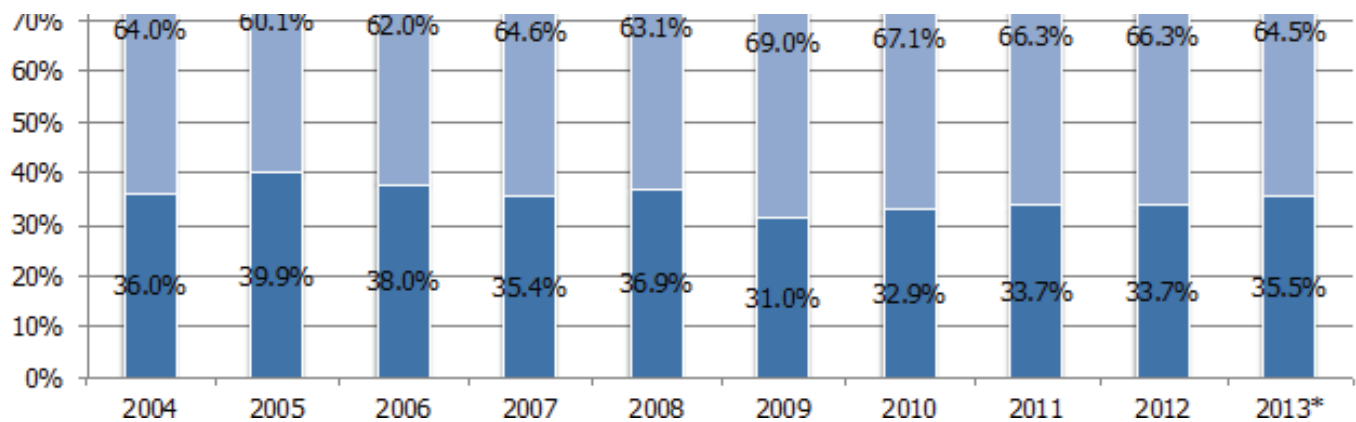


POST-REFORM OFFICIAL FINANCIAL FLOWS



receipts. The reform focused on strengthening the income tax base by closing corporate loopholes and reducing special exemption and incentives for specific sectors. The principle amendments for businesses include the elimination of several tax deductions and an additional 10% tax on dividends. Principle changes for individuals include the addition of three higher income brackets (32%, 34% and 35%) for annual income above MXN 750,000, 1 million and 3 million respectively, limitations on personal deductions, and a reduction in maximum exempt income from the sale of a home. The 16% Value Added Tax (VAT) was extended to previously exempt border zones and excise taxes on certain goods were increased.⁶⁰

MEXICAN PUBLIC SECTOR REVENUE



■ Oil related revenues ■ Non-oil related revenue

Source: "Finanzas Públicas," SHCP *Preliminary data for January to December 2013

Prior to privatization, the vast majority of taxes paid in the hydrocarbon sector came from Pemex. Private companies operating in the hydrocarbon value chain were taxed like any other company, primarily through the income tax and unique rate corporate tax.

With the implementation of the 2013 Energy Reform, the taxation of the hydrocarbon industry changed. The tax system was simplified and the level of taxation on petroleum production was lowered sharply. The intention of the reform is to impose lower taxes but generate the same revenues by increasing

60. PricewaterhouseCoopers, "Mexico 2014 Tax Amendment," November 2013, www.pwc.com/es_MX/mx/Reforma-hacendaria-2014/archivo/2013-11-boletin-ing.pdf

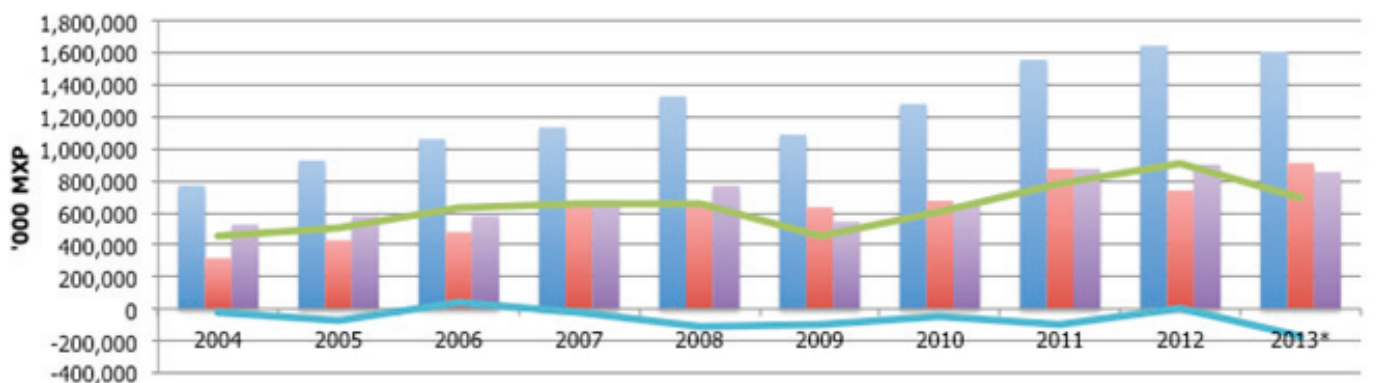
the “size of the pie.” However, this will take many years and in the mean time the Mexican Government still depends heavily on oil revenues. Under the law, the same taxes are imposed on Pemex and the IOCs it will compete with. However, as the owner of Pemex, the Mexican government through the SHCP has the option of collection annual dividends from the company to fill the income gap until the economy adjusts.

3.1.1 PRODUCER HYDROCARBON TAXES AND SUBSIDIES

Until the implementation of the 2013 Energy Reform, Pemex, as the sole producer of hydrocarbons in Mexico, was required to pass a large percentage of its income to the Mexican Government in the form of taxes, duties and benefits. Over the 10 years leading up to the reform, the company’s operating costs averaged only 51% of annual income. However, for eight of those years, its net income after taxes, benefits and duties were negative. In 2012, the Mexican Government collected 99.7% of Pemex’s MXN 905.3 billion operating income and 54.8% of its revenues.

Prior to the 2013 Energy Reform, the energy tax system was extremely complex. Pemex and its subsidiaries did not pay the same taxes as private companies operating in Mexico. They were not subject to the Income Tax Law (Ley del Impuesto Sobre la Renta) or the Flat Rate Business Tax Law (Ley del

PEMEX ANNUAL RETURN



■ Income ■ Operating costs and expenses ■ Taxes, duties, and benefits
 ■ Return before taxes, duties, and benefits ■ Net return

Source: Pemex Annual Financial Reports * Preliminary data for January to December 2013



Impuesto Empresarial a Tasa Única). Instead they were subject to ten separate taxes specific to the hydrocarbon sector.⁶¹

- The Ordinary Hydrocarbons Duty (*Derecho ordinario sobre hidrocarburos*, DOSH);
- The Extraordinary Duty on Crude Oil Exports (*Derecho extraordinario sobre la exportación de petróleo crudo*);
- The Hydrocarbons Duty for the Stabilization Fund (*Derecho sobre hidrocarburos para el fondo de estabilización*);
- The Duty for Scientific and Technological Research on Energy (*Derecho para la investigación científica y tecnológica en materia de energía*);
- The Duty for Oil Control (*Derecho para la fiscalización petrolera*);
- The Extraction of Hydrocarbons Duty (*Derecho sobre la extracción de hidrocarburos*);
- The Special Hydrocarbons Duty (*Derecho sobre la extracción de hidrocarburos*);
- The Additional Duty on Hydrocarbons (*Derecho adicional sobre hidrocarburos*);
- The Duty to Regulate and Supervise the Exploration and Exploitation of Hydrocarbons (*Derecho para regular y supervisar la exploración y explotación de hidrocarburos*); and
- The Hydrocarbon Income Tax (*Impuesto a los rendimientos petroleros*).

As of January 1, 2015 Pemex is subject to the same taxes as private companies producing hydrocarbons in Mexico. Pemex and private companies are subject to the Income Tax Law and the new Hydrocarbon Income Law.⁶² The Hydrocarbon Income Law lowers the tax on petroleum production from 71.5% to 65%.⁶³ Pemex and private oil companies also pay the normal corporate income tax and royalties defined under the contracting system based on the type of hydrocarbon produced.⁶⁴ Pemex and private oil

61. The DOSH makes up the majority of Pemex's tax burden and is paid by PEP. The DOSH is based on the value of total extracted production. In 2011 and 2013, the applicable rates were 71.5% and 72.5%, respectively. The Hydrocarbon Income Tax is paid by all subsidiaries besides PEP at the rate of 30% of excess of total revenues. The Hydrocarbons Duty for the Stabilization Fund, the Extraordinary Duty on Crude Oil Exports, the Special Hydrocarbons Duty, and the Additional Duty on Hydrocarbons are designed to capture any economic windfall caused by high oil and gas prices. They are based on excessive export price, national price, or field profits. The Extraction of Hydrocarbons Duty is only applied to specific fields and the Duty for Scientific and Technological Research on Energy and Duty for Oil Monitoring are both relatively low earmarked taxes, ranging from .65% to .003% of the value of the extracted production of crude oil and natural gas.

62. Diario Oficial de la Federación, *Ley de Ingresos Sobre Hidrocarburos*, 2014, www.diputados.gob.mx/LeyesBiblio/pdf/LIH_110814.pdf. Hereinafter: *Ley de Ingresos Sobre Hidrocarburos*.

63. Prior to the reform the tax on petroleum production was the The Ordinary Hydrocarbons Duty (*Derecho ordinario sobre hidrocarburos*, DOSH).

64. *Supra* note 62: *Ley de Ingresos Sobre Hidrocarburos*. Article 24.



companies can deduct real costs from their taxable income or choose to credit these deductions to future periods.

Though the taxes applied to Pemex and private oil companies are the same, the true financial burden of Pemex is greater. On top of the taxes levied the state, as owner of Pemex, may choose to collect an annual dividend. Under the law, the dividend may be reinvested in Pemex or entered into the public treasury. In December 2014, the SHCP announced that it would collect the entirety of the year's dividend of 50,000 million MXP. Luis Videgaray, the Secretary of the SHCP stated that it is the agency's intention to lower the annual total fiscal burden on Pemex by 90,000 million MXP over the next five years.⁶⁵ However, it remains to be seen if this goal will be met and if a portion of the dividend is reinvested in Pemex in the future.

3.1.2 CONSUMER HYDROCARBON TAXES AND SUBSIDIES

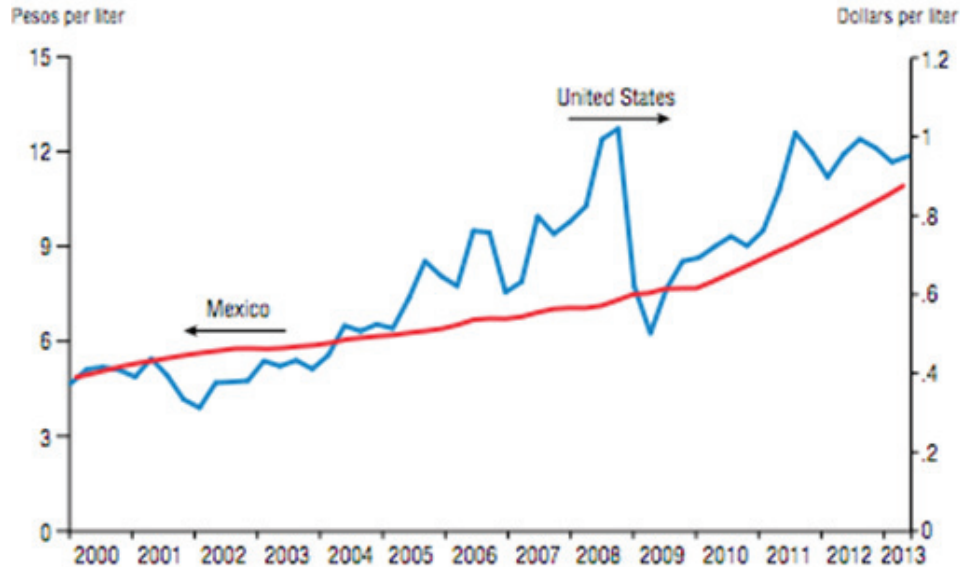
Prior to the implementation of the 2013 Energy Reform, the SHCP set gasoline and diesel prices on a monthly basis. The prices were set through the application of a negative or positive excise tax charged to customers, known as the Special Tax on Production and Services (*Impuesto especial sobre producción y servicios*, IEPS).⁶⁶ Price raises, known popularly as “gasolinazos,” were limited to 11 cents per month for gas and diesel. The price set by the SHCP was generally based on a formula that provided an estimate of Pemex's production, distribution, and retailing costs, but the SHCP could choose to set a different price if they wished. When the international price was above the price set by the government, the rate of IEPS becomes negative and acted as a subsidy. Conversely, when the international price was below the price set by the government, IEPS was positive and acted as a sales tax. As demonstrated by the graph below, since 2004, the Mexican price of gasoline has almost always been below the US price, which is determined by the free market.

65. Mauricio Rubí, “Menor carga fiscal, en 5 años: SHCP,” *El Economista*, August 12, 2014, eleconomista.com.mx/industrias/2014/08/12/menor-carga-fiscal-5-anos-shcp

66. Pemex, *Pemex 2012 Annual Report*, 2012, www.ri.Pemex.com/files/content/Annual%20Report%202012.pdf



UNITED STATES VS. MEXICAN GASOLINE PRICE PER LITER



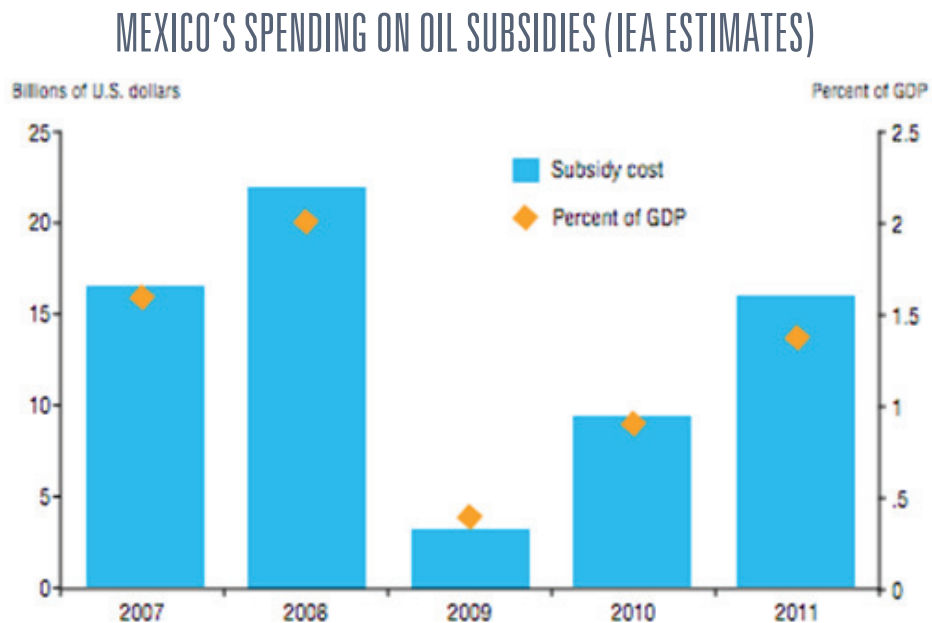
Source: Plante and Jordan, 2013

Consumption of hydrocarbons was further subsidized through a number of fuel tax credits for the agriculture and fisheries sectors, for commercial vessels, passenger and cargo transportation, and certain non-vehicle uses. Most tax credits apply only when the rate of IEPS is positive. They include:

- Diesel Tax Credit for Passenger and Cargo Transportation, which provides a tax credit applicable to purchases of diesel fuel to support the private and public transportation of passengers or cargo through roads and highways;
- Tax Credit for Marine Diesel, which provides a tax credit to final consumers of marine diesel fuel. The credit applies mostly to commercial shipping and related activities;
- Tax Credit for Purchased Diesel for Machinery, which provides a tax credit to the end users of diesel fuel in general machinery, with the exception of vehicles. Eligible uses include most commercial activities, with the exception of mining;
- Fuel-Tax Credit for Agriculture and Fisheries, which provides the agriculture, forestry, and fisheries sectors with a fuel-tax credit on their purchases of diesel fuel for final use in general machinery, with the exception of vehicles. Note that this tax-credit applies regardless of the IEPS rate.⁶⁷

67. OECD, *Mexico: Inventory of Estimated Budgetary Support and Tax Expenditures for Fossil-Fuels*, 2012, www.oecd.org/site/tadffss/MEX.pdf.

Mexican hydrocarbon subsidies are high, but lower than those of most major oil producing countries. The International Energy Agency (IEA) estimates that in 2011, Mexican spending on subsidies of gasoline, diesel and other oil products such as LPG ranked 7th internationally in dollar value and 19th as a percentage of GDP.⁶⁸



Source: Plante and Jordan, 2013

Note: The IEA includes subsidies on gasoline, diesel and other oil products, such as LPG (propane).

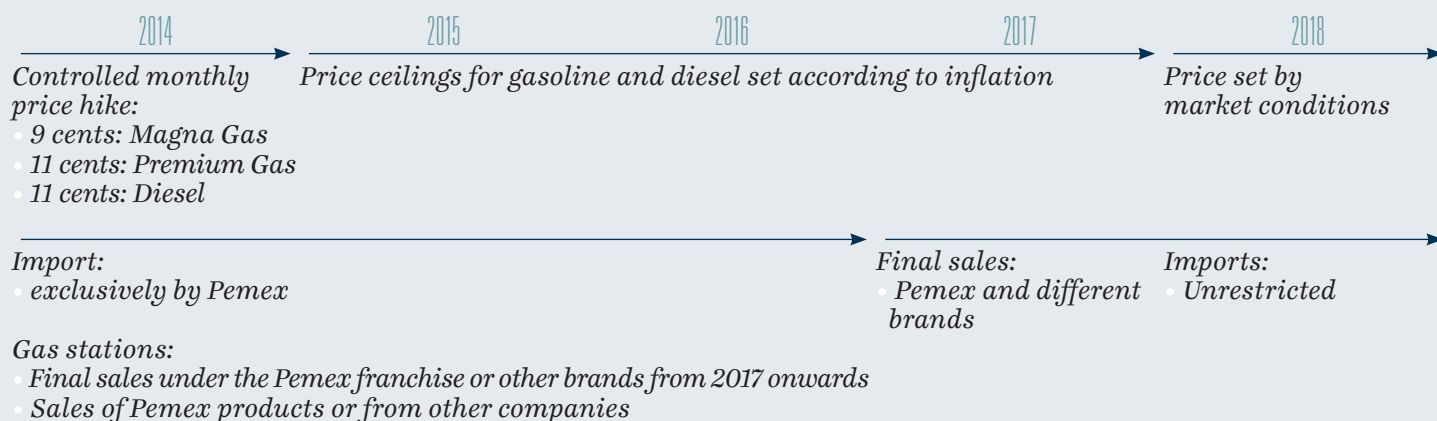
Subsidies paid to hydrocarbon consumers are not direct public sector transfers to a public or private actor in the hydrocarbon industry. However, they did affect those actors through their effect on domestic demand for gasoline and diesel. The subsidies lowered the price paid by consumers, increasing domestic demand, and therefore increasing producer profits. In this way, the Mexican Government indirectly transferred funds to Pemex through consumer hydrocarbon subsidies.

With the implementation of the 2013 Energy Reform, Mexican Government transfers to consumers represent an implicit transfer to private energy producers and importers as well. The reform includes a plan to phase out

68. Michael D. Plante and Amy Jordan, *Getting Prices Right: Addressing Mexico's History of Fuel Subsidies*, Southwest Economy (Federal Reserve Bank of Dallas, Third Quarter 2013), www.dallasfed.org/assets/documents/research/swe/2013/swe1303d.pdf.

government price controls. The SHCP ceased to set the price of diesel and gas starting January 1, 2015. The SHCP will maintain a price ceiling through 2017. However, the price may fluctuate under this ceiling based on market conditions. After 2017, the price ceiling will be removed and the price of gas and diesel in Mexico will be determined entirely by the market.

GRADUAL OPENING OF GASOLINE AND DIESEL MARKETS



Source: “The Energy Reform: Secondary Legislation,” SENER

3.2 DEBT

When Pemex’s net operating income and savings fall short of covering its expenses, it fills the gap with external financing from various lenders.⁶⁹ Pemex’s debt comes from both public and private sources. In 2012, 53.3% of Pemex’s debt came from international credit markets, 17.9% from the Mexican credit market, and 7.5% from bank loans, all private-sector sources of financing. 12.7 % of Pemex’s debt came from Export Credit Agencies, a quasi-public source of financing. 8.5% came from other sources.⁷⁰

In 2012, Pemex’s total assets were MXN 2,024.2 billion and total liabilities amounted to MXN 2,295.2 billion, giving the company a negative equity of MXN -271.1 billion. Assets are made up of property, plant and equipment as well as cash and cash equivalents. In 2012, Pemex owed MXN 1,288.5 billion

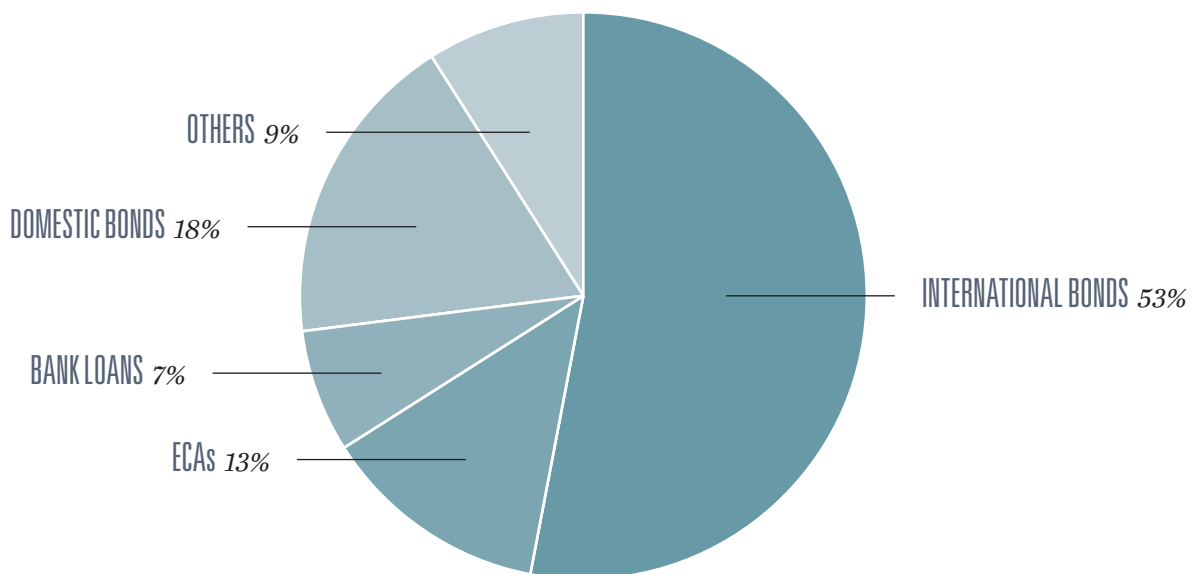
69. “Pemex Relación Con Inversionistas,” accessed March 20, 2014, www.ri.Pemex.com/index.cfm.

70. Pemex, *Pemex 2012 Annual Report*.



in employee benefits, over 60% of its total liabilities. Importantly, Pemex's current financing agreements do not include financial payment suspension covenants that could be triggered as a result of negative equity. Therefore, despite the company's negative equity, its employee benefit obligations remain in place.⁷¹

PEMEX'S DEBT BY INSTRUMENT AS OF DECEMBER 31, 2012



Source: Pemex 2012 Annual Report

3.2.1 DEBT FROM EXPORT CREDIT AGENCIES

Pemex's Export Credit Agencies (ECA) financing comes exclusively from foreign ECAs, primarily the United States Ex-Im bank and the Export Development Canada.⁷² Pemex holds no loans or insurance from Banco Nacional de Comercio Exterior, S.N.C. (Bancomext), the official ECA of Mexico. Foreign national ECAs extend loans to Mexican companies for the purchase of exports from the ECA's home country. Just as a department store provides credit cards to consumers without cash to encourage them to buy

71. *Ibid.*

72. *Ibid.*



the store's goods, ECAs facilitate loans to foreigners so they will buy their country's products.⁷⁵ Pemex's portfolio of ECA issued debt was primarily extended to Pemex to fund the purchase of imported equipment from the US and Canada.

3.2.2 BONDS

All of Pemex's domestic Mexican debt is issued in the form of *Certificados Bursátiles Bancarios* (Cebures), or publically traded, peso-denominated bank notes. The Bolsa Mexicana de Valores (BMV), Mexico's stock market, acts as underwriter and manager in the issuance of Pemex's Cebures. Debt offered in the form of international and national bonds is sold on the public market and may be bought by individual or institutional investors. Pemex's bonds are issued both directly by the absolute parent company, *Petróleos Mexicanos*, and by its subsidiary, Pemex Finance. Pemex Finance is a limited liability company incorporated in the Cayman Islands. It uses the proceeds of the notes it issues to purchase accounts receivable which are generated through the sale of crude oil to designated customers of P.M.I. Comercio Internacional, S.A. de C.V.⁷⁴ The debt on Pemex's balance sheet is circumscribed within the debt ceiling authorized by the Mexican Congress.

3.3 CONTRACTS

FINANCIAL FLOWS ASSOCIATED WITH GOVERNMENT NATURAL RESOURCE CONTRACTS, LICENCES, AND PERMITS*

STATE → COMPANY

Contract, licence, or permit allowing exploitation of hydrocarbon. Though this is not money, it is an asset worth money and therefore can be analyzed as a financial flow.

COMPANY → STATE

Fixed fee or a share of production, depending on the terms of the contract.

* *The state owns the natural resource in the ground*

73. Aaron Goldzimer, *Globalization's Most Perverse Secret: The Role of Export Credit and Investment Insurance Agencies*, Presented at the Alternatives to Neoliberalism Conference sponsored by the New Rules for Global Finance Coalition, (May 2002).

74. "Pemex Relación Con Inversionistas."



3.3.1 PRE 2013 ENERGY REFORM

Prior to the 2013 Energy Reform, Pemex had a constitutional monopoly over the upstream oil industry. All permits for survey and surface exploration and allocations for E&P of oil were issued to Pemex.

However, the 1992, 1996, 2001, and 2008 Energy Reforms allowed specific contracts between Pemex and private sector third parties relating to exploration, development, repair, maintenance, research, and transportation of gas, oil and petrochemicals. Permitted contracts between Pemex and private companies include:

- *Contratos de Obra Pública Financiada (OPF) or Contratos de Servicios Múltiples (CSM)*
 - issued between 2001 and 2007 by Pemex Exploration and Production (PEP)
- *Contratos de Laboratorios Integrales de Campo (CLIC);*
- *Acuerdos científicos y tecnológicos no comerciales*
 - issued by PEP
- *Contratos de Servicios Transaccionales*
- *Contratos Integrales de Exploración y Producción (CIEP)*

Of the contracts above, the only ones that allow private investment into E&P projects is the CIEP, created by the 2008 Energy Reform. They allow Pemex to sign fee-per-barrel contracts with private companies for fields that require advanced technology, such as mature fields and deep-water reserves. Under fee-per-barrel contracts, IOCs accept a fixed fee per barrel of oil instead of an equity stake. They do not allow foreign oil companies to include Mexican crude in calculations of their own reserves, which financial analysts view as a prime indicator of an energy company's health. The fee-per-barrel contracts and the mostly mature, almost abandoned fields failed to attract significant IOC investment.

Private companies have had the right to participate in the downstream gas sector since the 1995 CRE Act (Ley de la Comisión Reguladora de Energía). However, no single company could participate in more than one industry function (transportation, storage, or distribution).

Additionally, Pemex sources goods and services from the private sector, ranging from uniforms to medicine. As discussed in section 2.5 [Public Procurement Oversight](#), Pemex has its own public procurement framework parallel to that of the federal government.



3.3.2 POST 2013 ENERGY REFORM

Under the 2013 Energy Reform, the ownership of underground hydrocarbon resources remains in the hands of the state, but private companies as well as Pemex may bid for government hydrocarbon contracts. During Round Zero, now complete, Pemex was awarded 81% of total 2P reserves and 21% of total prospective reserves in the form of entitlements. Round One, the first round of bidding open to private national and international oil companies, was launched on December 11, 2014 and is ongoing.⁷⁵

For the fields granted to Pemex in Round Zero, Pemex may apply to migrate projects from entitlements to contracts. Once Pemex migrates a project to a contract, it may subcontract the project with a private company. The bidding process for E&P subcontracts issued by Pemex will be conducted by the CNH.

After Round Zero, starting with Round One, CNH will openly conduct the bidding process for contracts for the remaining reserves and prospective reserves, as defined by SENER. Pemex and private parties may also nominate areas for contract as well. Pemex and private parties may sign contracts individually or in partnership. In any contract, the state may have up to 30% direct financial participation and in trans-boundary fields is required to have a minimum of 20% financial participation.

Though bidding will be open to both national and foreign companies, there are minimum national content quotas, giving national companies an advantage. Projects must have an average local content of 25% by 2015, and 35% by 2025, excluding deep-water projects.

Contracts created by the 2013 Energy Reform will allow foreign oil companies to include Mexican crude in calculations of their own reserves, also called booking reserves. This is important because financial analysts view reserve values as one of the primary indicators of an energy company's strength. President Peña Nieto and his cabinet prioritized allowing private companies to book reserves as part of the reform. Prior to unveiling the proposed reform in the summer of 2013, PEMEX and top Mexican officials held talks with the U.S. Securities and Exchange Commission (SEC) to make sure foreign investors listed in US markets would be able to book their share of profits from the Mexican contracts as reserves.⁷⁶ Foreign oil companies were not

75. See section 1.2 for more detail on Round Zero and Round One.

76. Guy Chazan, "Oil Majors Welcome Mexico's Opening of Energy Sector to Outsiders," *Financial Times*, August 13, 2013, sec. Companies, www.ft.com/intl/cms/s/0/aecb34f6-0417-11e3-a8d6-00144feab7de.html#axzz3P20JCASo.

allowed to book reserves under the CIEP contracts introduced by the 2008 Energy Reform, which is widely considered as one of the reasons that the reform failed to attract significant investment.

Under the 2013 Energy Reform, the Mexican government also issues contracts and permits to Pemex and private parties for refinement, basic petrochemicals production, transport, storage, and first hand sale of hydrocarbons. Pemex will maintain its monopoly on gas and diesel import and final sales through 2016, after which both will be open to outside competition. Production of secondary petrochemicals does not require special government contracts or licenses.

4. FINANCIAL FLOWS IN THE HYDROCARBON INDUSTRY INVOLVING NON-STATE, NON-PRIVATE SECTOR ACTORS

As discussed in the previous section, the principle official financial flows in the Mexican hydrocarbon sector are taxes, debt and contract payments that take place among the government, Pemex, private sector companies, investors, and financial institutions. However, in reality, there are a number of other groups with vested interests that generate additional, at times less obvious, financial flows. Three central groups in this category are labor, affected communities, and organized crime groups.

4.1 LABOR

Pemex workers are both the source and recipient of significant financial flows in the Mexican hydrocarbon industry. The STPRM, a powerful political actor in itself, receives large amounts of money in the form of union dues from workers, earmarked funds set aside in the semi-annual collective contract negotiated between the STPRM and Pemex, and loans from Pemex. Additionally, beyond normal salaries, funds are transferred from Pemex to workers in the form of social spending and benefits.

4.1.1 THE STPRM

As of August 2013, Pemex had 153,233 workers, approximately 120,000 of which were members of the STPRM.⁷⁷ The STPRM is the exclusive union

77. Luis Carriles, “¿Cuántos Empleados Tiene Pemex?” *El Economista*, August 20, 2013, eleconomista.com.mx/diario-reforma-energetica/2013/08/20/cuantos-empleados-tiene-Pemex.

of Pemex. There are no alternative Pemex unions and the STPRM has not unionized private companies. However, it is possible that with the privatization of the sector, the STPRM will negotiate collective agreements with other IOCs.

The STPRM signed its first collective bargaining agreement with Pemex in 1942. Every two years the STPRM re-negotiates its collective bargain with Pemex, which establishes salaries and benefits for Pemex workers. The most recent collective bargaining agreement between Pemex and STPRM entered into force on August 1, 2013 and is valid through 2015.⁷⁸

The STPRM is a famously opaque institution. This opacity extends to its structure and leadership. The Secretary General leads the union. He or she is selected by the union's executive committee, made up of representatives from the union's 36 sections. The currently elected Secretary General is Jorge Hernández Lira. However, it appears that his predecessor, Carlos Romero Deschamps, continues to act as *de facto* Secretary General. Romero Deschamps first took over leadership of the union from his infamous predecessor, Joaquín Hernández Galicia "La Quina," in July 1993. Since 1993, he has been continuously re-elected, most recently for the 2012 to 2018 term. However, in November 2012, the executive committee of the STPRM voted to dismiss Romero Deschamps and replace him with Hernández Lira.⁷⁹ Despite this, Romero Deschamps has stated his intention to serve out his full term. His continued leadership of the union is recognized by Pemex, but seems to go against the wishes of certain factions within the union.⁸⁰ Deschamps has previously stirred up controversy for his involvement in "Pemexgate," discussed below, and his lavish lifestyle.⁸¹ Romero Deschamps continues to serve as a Federal Senator and is a member of the Institutional Revolutionary Party (Partido Revolucionario Institucional, PRI).

Money flows from Pemex to the STPRM through workers' salaries in the form of union dues (*cuotas sindicales*), direct allocations in the collective contract, and loans. All STPRM members, over three-quarters of all Pemex

78. Petróleos Mexicanos y el Sindicato de Trabajadores Petroleros de la República Mexicana, "Contrato Colectivo de Trabajo 2013-2105," 2013, www.Pemex.com/acerca/informes_publicaciones/Documents/contrato_colectivo/cct_2013-2015.pdf.

79. According to official documents, the reason for his dismissal was that he abandoned the defense of the workers' labor rights and was involved in traffic of influences and abuse of power. Source: "A La Opinion Pública Reg. № 1131/35" (Comité Ejecutivo General, Sindicato de Trabajadores Petroleros de la República Mexicana, November 7, 2012), www.scribd.com/doc/127381187/A-LA-OPINION-PUBLICA.

80. "Romero Deschamps: Décadas de Impunidad," *Proceso*, accessed July 8, 2014, www.proceso.com.mx/?p=335568.

81. See: "Romero Deschamps Da 'Regalito' a Su Hijo: Un Enzo Ferrari de 2 Millones de Dólares," *Proceso*, February 23, 2013, www.proceso.com.mx/?p=334462.

employees, are required to pay a certain percentage of their salary in union dues. These union dues are deducted from workers' salaries and delivered directly from Pemex to the union. In 2009, union dues made up 2% of Pemex employees' salaries.⁸² By law, the funds are paid to workers and then transferred to the union. However, in practice, at no point do workers have access to these funds.

In addition to union dues, the collective bargains allow for earmarked funds and loans from Pemex to the STPRM. In the collective bargain, funds may be earmarked to "help with costs"⁸³ for celebrations and other special expenses and paid directly from Pemex to the union. Loans from Pemex to the union are also permitted. They require no specific justification, but must be approved by the Director General of Pemex. Prior to 2004, direct transfers associated with the collective bargain were not made public. Documentation suggests that they were verbally negotiated. In 2004, a covenant was signed regarding earmarked funds delivered directly from Pemex to the STPRM and from then on they have been published with the collective bargaining agreement in clause 251a.⁸⁴ Though small compared to union dues, earmarked funds transferred from Pemex to the STPRM have averaged over MXN 100 million annually.

Loans from Pemex to the STPRM have been a source of illicit flows in the past. In the scandal known as "Pemexgate," PEMEX channeled money to the PRI through the STPRM. In 2000, PEMEX made two loans to the STPRM totaling over 1 billion MXP. The STPRM then passed this money to the campaign of Francisco Labastida Ochoa, the PRI candidate for president. The President of the Democratic Revolutionary Party (Partido de la Revolución Democrática, PRD) accused PEMEX of channeling money to the PRI presidential campaign before the SFP.⁸⁵ The Attorney General and the Federal Electoral Institute (Institute Federal Electoral) carried out the investigation. In 2001, the Federal Electoral Institute audited banking records through the National Banking and Securities Commission (Comisión Nacional Bancaria y de Valores) and confirmed the illicit flow.⁸⁶ STPRM

82. Noé Cruz Serrano, "Cuotas Sindicales, Arcas Millonarias Inauditables," *El Universal*, August 19, 2009, www.eluniversal.com.mx/finanzas/72990.html.

83. "ayudas con gastos," Source: Petróleos Mexicanos y el Sindicato de Trabajadores Petroleros de la República Mexicana, "Contrato Colectivo de Trabajo 2013-2105."

84. Patricia Muñoz Ríos, "Otorgará Pemex al sindicato petrolero más de 141 millones de pesos para festejos," *La Jornada*, March 11, 2013, sec. Política, www.jornada.unam.mx/2013/03/11/politica/012n1pol.

85. Then called the Ministry Secretary of the Comptroller and Administrative Development (Secretaría de la Contraloría y Desarrollo Administrativo)

86. For more detailed information on the investigation, see: Lorenzo Cordova and Ciro Murayama, *Elecciones, Dinero y Corrupcion: Pemexgate y Amigos De Fox* (Aguilar, León y Cal Editores, 2006).



leaders, including Carlos Romero Deschamps and Ricardo Aldana, STPRM treasurer, were implicated in the scandal. However, neither was ever charged as both were sitting members of congress and enjoyed legislative immunity. Criminal charges were brought against Rogelio Montemayor, the Director General of Pemex during the scandal. In 2005, the SFP fined Montemayor along with five other former Pemex officials a combined \$2.8 billion MXP.⁸⁷

The example of “Pemexgate” gives insight into the influence asserted by the PRI over PEMEX and the STPRM and vice versa. Both Rogelio Montemayor and Carlos Romero Deschamps are long-time PRI party leaders. Montemayor had previously served as Governor of Coahuila State and Deschamps is a sitting member of Congress. The fact that Deschamps stayed in power during the presidency of Vicente Fox, the first National Action Party (Partido Acción Nacional, PAN) president, and that no significant measures were taken to prevent corruption in the STPRM during Fox’s presidency implies that the PAN may have developed ties with the labor group as well.⁸⁸

Until recently, STPRM spending was a black box. The established jurisprudence held that neither the amount of money annually transferred to the union in union dues nor the annual budget of the union were public information subject to government transparency mechanisms. Courts held that the total amount paid annually in union dues is not governmental information because it does not represent public resources, but rather a portion discounted from workers’ salaries, and therefore is private by nature.⁸⁹ However, the 2014 Transparency Reform bill gave government oversight agencies full jurisdiction over political parties and unions that receive and use public resources, including the STPRM.⁹⁰ It states, as was already true of government agencies, that information relating to unions and political parties is public and “and can only be temporarily reserved for public interest and national security, in the terms established by law.”⁹¹

87. Elizabeth Velásco C., “Puede llevarse años cobrar multas del Pemexgate,” *La Jornada*, May 12, 2005, sec. Política, www.jornada.unam.mx/2005/05/12/index.php?section=politica&article=005n3pol.

88. Magally Macías Flores, “Dos casos de corrupción del gobierno mexicano: FOBAPROA y PEMEXGATE” (Universidad de las Américas Puebla, 2010), catarina.udlap.mx/u_dl_a/tales/documentos/lri/macias_f_m/portada.html.

89. For a full discussion of the jurisprudence, see: Alfredo Sánchez-Castañeda, “La Rendición de Cuentas de los Sindicatos: Las Cuotas Sindicales,” *Revista Latinoamericana de Derecho Social* 15, no. Julio-Diciembre de 2012 (December 2012): pp. 187–99.

90. Diario Oficial de la Federación, *Decreto por el que se reforman y adicionan diversas disposiciones de la Constitución Política de los Estados Unidos Mexicanos, en materia de transparencia*, February 7, 2014, www.dof.gob.mx/nota_detalle.php?codigo=5332003&fecha=07/02/2014.

91. *Ibid.* In Spanish, “sólo podrá ser reservada temporalmente por razones de interés público y seguridad nacional, en los términos que fijen las leyes.”



The 2014 Transparency Reform opened the way for the transparentization of the STPRM. However, the process is still incomplete and much of the information on the union made transparent under the law is still unavailable to both the federal government and civil society.

4.1.2 SOCIAL SPENDING

Both Pemex and the STPRM provide social services to Pemex workers. Salaries along with benefits are negotiated in the collective contract between Pemex and the STPRM. Pemex benefits are wide-ranging.⁹² In addition to contractual benefits, Pemex workers have their own health system, separate from the national healthcare system, paid for by Pemex. As of July 2013, Pemex health services operated 20 hospitals, 7 clinics, and 204 smaller medical units. In 2012, Pemex spent MXN 11,844.67 million on health services.⁹³ At the end of 2012, Pemex's balance sheet indicated that the company had MXN 1,288.5 billion in reserve for employee benefits, over 60% of the company's total assets for the year.⁹⁴

The STPRM uses some portion of its budget to organize social events and provide childcare and other social services. In order to provide these services the STPRM has an internal procurement process that is completely opaque and currently not part of the public procurement oversight framework.

4.2 AFFECTED COMMUNITIES

The hydrocarbon industry affects Mexican communities and individuals through the expropriation of land, use of scarce resources, and environmental degradation. Most often it is through *ejidos* or *comunidades* that affected communities have registered complaints and organized campaigns against the extractive industry.

4.2.1 EJIDOS AND COMUNIDADES

In Mexico, in addition to individual land ownership, *ejidos* or *comunidades* may own land collectively. Land reforms brought about by the Mexican Revolution (1910-1920) redistributed land to groups of households organized

92. See the most recent collective contract: Petróleos Mexicanos y el Sindicato de Trabajadores Petroleros de la República Mexicana, "Contrato Colectivo de Trabajo 2013-2105." www.pemex.com/acerca/informes_publicaciones/Documents/contrato_colectivo/cct_2013-2015.pdf

93. "Pemex Servicios de Salud," accessed July 8, 2014, www.Pemex.com/servicios/salud.

94. Pemex, *Pemex 2012 Annual Report*.



into *ejidos* and indigenous groups organized into *comunidades*. *Ejido* members have voting rights through the General Assembly through which they elect a leader, or *comisariado*. In order to retain their holdings *ejidatarios* must fulfill mandatory work requirements and maintain the land in agricultural production. The government of Mexico often distributes social benefits through the *ejidal* structure. In 1992, a constitutional amendment officially brought the revolutionary land reform to an end. The amendment ended the expansion of *ejidos* and allowed leasing and sale of *ejidal* land. However, *ejidos* and *comunidades* continue to hold a large amount of land in Mexico and are an important element of rural social organization. According to the most recent *Ejidal Census*, there are 31,514 *ejidos* and *comunidades* across Mexico that collectively hold 105, 948,306 hectares of land.⁹⁵

4.2.2 EXPROPRIATION

Expropriation of land is a financial flow from the original holder of the land to the expropriating body. Payment for the expropriated land is a financial flow from the expropriating body to the original holder. However, even when original owners are compensated for their land, there is an inevitable imbalance of power in the process because the expropriating body has the right to demand the land and the original owner does not have the right to refuse.

The Mexican Constitution provides that private property may be expropriated with compensation for “public utility,” and the amended Hydrocarbon Law (*Ley de Hidrocarburos*) establishes the hydrocarbon industry as a public utility. It gives E&P of hydrocarbons precedent over any other use of the surface or subsoil.⁹⁵ The law does not differentiate between projects realized by Pemex and private companies in its definition of public utility and makes no mention of land conserved for environmental or cultural reasons. Under the law, the state may oblige landowners, including *ejidos* and *comunidades*, to cede land through a legal easement (*servidumbre legal*). Once contracts for hydrocarbon E&P are granted to private companies, those companies may use legal easements to expropriate land for almost any activity associated with the exploration and extraction permitted in the contract.⁹⁷

95. *Censo Ejidal 2007* (Instituto Nacional de Estadística y Geografía), accessed July 28, 2014, www.inegi.org.mx/est/contenidos/proyectos/agro/ca2007/resultados_ejidal/default.aspx.

96. Presidencia de la República, “Ley de Hidrocarburos,” April 28, 2014, cdn.reformaenergetica.gob.mx/1-ley-de-hidrocarburos.pdf. Article 58.

97. Specifically, transport of people; transportation and storage of construction materials, vehicles and machinery; construction and maintenance of infrastructure or any other works necessary for the adequate development and monitoring of the activities permitted by a contract or allocation (*contrato* or *asignación*). *Ibid.* Art. 102



Expropriation of land for use by the private sector is not unprecedented in Mexico. Under the Mining Law (Ley Minera), private companies awarded mining concessions may expropriate privately held land within that concession for almost any activity associated with the extraction of minerals.⁹⁸

Chapter five of the amended Hydrocarbons Law creates a mandatory social impact evaluation process. Under the law, a social impact evaluation must be submitted to SENER before the development of any hydrocarbon project. The law specifically requires prior consultation of *comunidades* and *pueblos indígenas* (indigenous communities).⁹⁹

However, it is unclear that the social impact evaluation will meaningfully enhance the rights of vulnerable rural populations. There is no language implying that a project could be canceled or delayed as a result of the outcome of the evaluation. Additionally, as a social impact evaluation has yet to be carried out, it is hard to know how thorough they will be in practice.

4.2.3 NEGATIVE AND POSITIVE EXTERNALITIES

Communities, even those whose land is not expropriated, may be adversely affected by nearby hydrocarbon activity. For example, an oil spill may contaminate a nearby community's water source. In such a case, the community bears the costs of the hydrocarbon industry's negative production externality. A negative production externality occurs when a firm's production reduces the well being of others who are not compensated by the firm. Though there is no exchange of money, there is an implicit financial flow from the affected community to the company. The company generated the negative externality and benefitted from it (i.e. they were able to profit from the extraction of hydrocarbons), but the community pays the price.

Communities may also benefit from nearby hydrocarbon industry activity both indirectly, for example through improved infrastructure constructed for the transport of extracted resources, and directly, such as when a hydrocarbon company provides social services to a nearby community in order to placate community members unhappy with its activities. These

98. Specifically, for installation, storage plants and other facilities, easement of access, power and water lines, and use of subsoil waters. *Mexico - Property Rights and Resource Governance*, Country Profile (USAID), accessed July 28, 2014, usaidlandtenure.net/sites/default/files/country-profiles/full-reports/USAID_Land_Tenure_Mexico_Profile.pdf.

99. Presidencia de la República, "Ley de Hidrocarburos." Articles 118 through 121.



both represent financial flows from the hydrocarbon company to the affected community.

4.3 ORGANIZED CRIME

Organized crime groups, specifically drug cartels, are important social, political, and economic actors in Mexico. Over the last decade, cartels have diversified from the trafficking of illegal drugs into a wide range of income-producing activities. As a result, extortion, kidnapping, and car theft have increased. Additionally, cartels have increased oil and other natural resource theft and moved into activities not traditionally associated with organized crime. The Zetas, considered by the US government to be the most technologically advanced and sophisticated cartel in Mexico, led this diversification, which has been emulated by other groups.¹⁰⁰ Diversification provides cartels with income when drug trafficking comes under pressure. Additionally, as cartels have splintered over the last decade, smaller, less powerful groups that are unable to compete in the international drug trade have looked to resource theft for income. Currently, throughout the entirety of Mexico organized crime groups are important economic actors in the hydrocarbon industry through theft, extortion, and money laundering operations.

4.3.1 THEFT

Gasoline theft can be anything from a family tapping a pipeline running near their property and selling it on the side of the road, to a large-scale, organized industry. In recent years, fuel theft in Mexico has become more sophisticated, lucrative, and widespread. Between 2000 and 2014, Pemex reported a 1548% increase in oil theft through illegal siphoning.¹⁰¹ In 2013, Pemex reported 2,614 illegal taps on pipelines transporting gasoline, diesel, crude oil, natural gas, and petrochemicals, compared to 155 reported in 2000.¹⁰² The CEO of Pemex, Emilio Lozoya, stated publicly that fuel robberies cost the company more than 15 billion MXP in 2012 and the first nine months of 2013 (considered a low estimate by some). Furthermore, the cost to Pemex is trending upwards, with more than

100. Patrick Corcoran, “Evaluating the Zetas’ Legacy in Mexico,” *InSight Crime*, June 18, 2014, www.insightcrime.org/news-analysis/evaluating-the-zetas-legacy-in-mexico.

101. “Cocaine & Crude.” (VICE News, August 2, 2014), news.vice.com/video/cocaine-crude-full-length. Hereinafter “Cocaine & Crude.”

102. Noé Cruz Serrano, “Crimen ‘ordeña’ siete ductos de Pemex al día,” *El Universal*, February 3, 2014, sec. Finanzas, www.eluniversal.com.mx/finanzas-cartera/2014/crimen--39ordenia-39-siete-ductos-de-pemex-al-dia-984493.html.



half of the 15 billion-peso cost accrued between January and September of 2013.¹⁰³

Fuel theft in Mexico, which was once primarily carried out by small-time thieves and corrupt Pemex employees, has evolved into a massive business for organized crime groups. The idea that organized crime groups are driving the acceleration in fuel theft is supported by the geography of the theft. Though illegal taps were detected in all states, Pemex identified Tamaulipas, Veracruz, Sinaloa, the State of Mexico, and Jalisco as the worst hit. The Zetas, the drug cartel believed to be most active in natural resource theft, are active in all but the State of Mexico.¹⁰⁴

As cartels have increased their involvement, thefts and methods of commercialization have become more sophisticated. Oil and oil by-products may be stolen by tapping pipes or, in extreme cases, thieves simply drive into Pemex plants and fill their trucks. Gasoline is the easiest oil byproduct to commercialize. Black market gasoline is sold on the side of the road throughout Mexico. Increasingly, as the black market has grown, stolen gasoline is also sold through official Pemex gas stations. On June 15, 2012 the National Organization of Petroleum Retailers (Organización Nacional de Expendedores de Petróleo, A.C, Onexpo) filed a complaint with the Attorney General's Office alleging that criminal groups are forcing gas station owners to sell stolen fuel.¹⁰⁵ Additionally, large organized crime groups, with the help of extensive infrastructure and networks of corrupt officials, have successfully stolen and commercialized stolen oil and gas internationally, in the US and Guatemala. In 2010, five US companies were sentenced in connection with Mexican oil theft: Trammo Petroleum, BASF Corp, Valley Fuels Ltd, Murphy Energy Corp, and US Petroleum Depot.¹⁰⁶ In 2013, Pemex filed two lawsuits in US federal courts against companies that allegedly purchased stolen gas from the Zetas.

The extent and effectiveness of robbery from Pemex implies extensive insider cooperation. In her book, *El Cártel Negro*, Ana Lilia Pérez outlines the close ties between Pemex workers and organized crime groups. Driving off with gasoline stolen directly from a plant requires at least compliance, if not help, from the entire Pemex staff present. According to Pérez, even tapping

103. Patrick Corcoran, "Mexico's Oil Reform May Help Organized Crime," *InSight Crime*, February 11, 2014, www.insightcrime.org/news-analysis/mexicos-oil-reform-may-help-organized-crime.

104. James Bargent, "Oil and Gas Theft in Mexico Doubled in 2013," *InSight Crime*, May 10, 2013, www.insightcrime.org/news-briefs/oil-and-gas-theft-in-mexico-doubled-in-2013.

105. Tracey Knott, "Mexico Gas Vendors Forced to Buy Fuel Stolen by Gangs," *InSight Crime*, March 23, 2011, www.insightcrime.org/news-briefs/mexico-gas-vendors-forced-to-buy-fuel-stolen-by-gangs.

106. *Supra* note 101: "Cocaine & Crude."



pipelines successfully requires access to the piping schedules and technical knowledge that only a person trained by Pemex would have. Additionally, the interference of the STPRM makes it difficult to punish offenders and has led to a widespread cover up of the issue.¹⁰⁷ Between 2004 and 2014, roughly 97 Pemex workers and 7 contractors have been accused of crimes linked to fuel theft, very few when compared to the scale of the theft that occurred over the same period.¹⁰⁸

4.3.2 EXTORTION

Beyond illicit commerce, Mexican drug cartels may seek profits and influence through extortion. They engage in both generalized extortion of all actors within their area of control, known euphemistically as “protection,” and targeted extortion, for example kidnapping.

In areas where the state lacks control, drug cartels impose a “protection” tax on everyone from individual vendors to mid-scale businesses. Criminal groups go after the easiest targets first, and generally small companies are most vulnerable to this kind of regular, systematic extortion. The Assistant Attorney General’s Office for Special Investigations on Organized Crime (Subprocuraduría de Investigación Especializada en Delincuencia Organizada, SEIDO), the federal office in charge of policing organized crime, assumes in its estimates that only companies with 50 employees or fewer are vulnerable to this type of extortion. It is unlikely that large companies, such as IOCs and large national and international oil service companies, are vulnerable to regular “protection” extortion. However, small providers of goods and services throughout the hydrocarbon value chain are.

Large companies are vulnerable to opportunistic extortion, such as kidnapping. Roughly 50 Pemex workers were kidnapped between 2009 and 2014. The most dramatic case in recent history was the disappearance of 38 workers from the Burgos Basin in 2007.¹⁰⁹ The arrival of rich IOCs will likely provide further opportunity for kidnapping. Colombia provides a pertinent example of how organized crime can evolve with the privatization of the hydrocarbon sector. Organized crime interaction with the hydrocarbon industry is still relatively new in Mexico, while in Colombia it has been funding paramilitary groups for over four decades. There are paramilitary groups that started out in oil theft and leaders that started out dealing in

107. Ana Lilia Pérez, *El Cártel Negro* (Penguin Random House Grupo Editorial México, 2011).

108. *Supra* note 101: “Cocaine & Crude.”

109. *Ibid.*



contraband petroleum (for example, “Marquitos”). After Colombia opened its energy sector to private investment in 1994, the incidents of kidnappings spiked. Big, rich oil companies proved attractive targets. Crime was brought back to pre-reform levels when the Colombian government flooded the oil rich region with military police. The Colombian government paid for these police through Plan Colombia, which was paid for by the US government. The company being targeted by Colombian paramilitary kidnappers was Occidental Petroleum, a US company. Overall, the entrance of IOCs in Colombia did not affect the long-term level of organized crime activity. It is reasonable to expect that, as in Colombia, the entrance of IOCs in Mexico could lead to a short-term jump in targeted extortion and fail to improve the overall level of theft in the long term.¹¹⁰

4.3.3 MONEY LAUNDERING

Money laundering is the term used to describe the process of channeling illegally gained money through legal businesses in order to transform it into ostensibly legal money or other assets. Criminal groups use companies contracted to provide services to the hydrocarbon industry in order to launder money. They may create shell companies that win contracts awarded by corrupt officials for services that will never be delivered. Or, they may run functional companies that legitimately win bid-tenders, provide the services promised, but are also used to hide and move illicit flows.

Companies that deal in foreign currencies, for example oil service companies that import machinery from the US, are particularly attractive targets for criminal groups because they provide a means of converting earnings between currencies. Trafficking drugs to the US is the single most lucrative activity for criminal groups in Mexico. These drugs are generally sold in the US for US Dollars. The profits are then brought back to Mexico or Central and South America. A criminal group cannot change millions of dollars from USD to MXP at a bank without drawing attention to itself. However, by channeling USD denominated drug profits through a Mexican company that deals in foreign currencies, illegal drug profits denominated in USD can be disguised and converted to other currencies.

One recent example of an oil service company used by an international drug cartel to launder money is ADT Petroservicios. The company had millions of dollars in contracts with Pemex while allegedly laundering money for the Zetas. The head of the company, Francisco Antonio Colorado Cessa,

110. Interview with Steven Dudley, Co-director of InsightCrime, Washington DC, August 8, 2014.



was arrested in Texas in 2012 and the company was blacklisted by the US Treasury Department later that year.¹¹¹

5. TRACKING ILLICIT FINANCIAL FLOWS IN THE MEXICAN HYDROCARBON INDUSTRY

This section utilizes the framework developed in the *Theoretical Framework for Financial Flows in the Extractive Sector* and applies it to the actors, economic flows and oversight relationships specific to the Mexican hydrocarbon industry. By considering significant gaps in oversight of legal flows and flows involving illicit actors, this section seeks to track potential for illicit flows throughout the Mexican hydrocarbon industry. We do not identify specific real-life examples of illicit flows, but rather consider stages or transaction where the opportunity for illicit flows exists. Any examples listed are hypothetical. The analysis in this section makes frequent reference to findings from previous sections of this report.

In order to track each illicit flow, the report identifies the type of illicit flows that is most likely to occur in each situation and the phases in the hydrocarbon value chain that are most vulnerable.

Illicit financial flows fall into one of four categories: corruption, illegal exploitation, tax evasion, and third party theft. Though each category of illicit flow has unique characteristics worth discussing, they are not completely separable; the categories coexist and overlap.

111. María Idalia Gómez and Ramón Sevilla, “Anatomía de La Red de Francisco Colorado, El Empresario de Los Zetas,” *24 Horas*, June 14, 2012, www.24-horas.mx/anatomia-de-la-red-de-francisco-colorado-el-empresario-de-los-zetas.

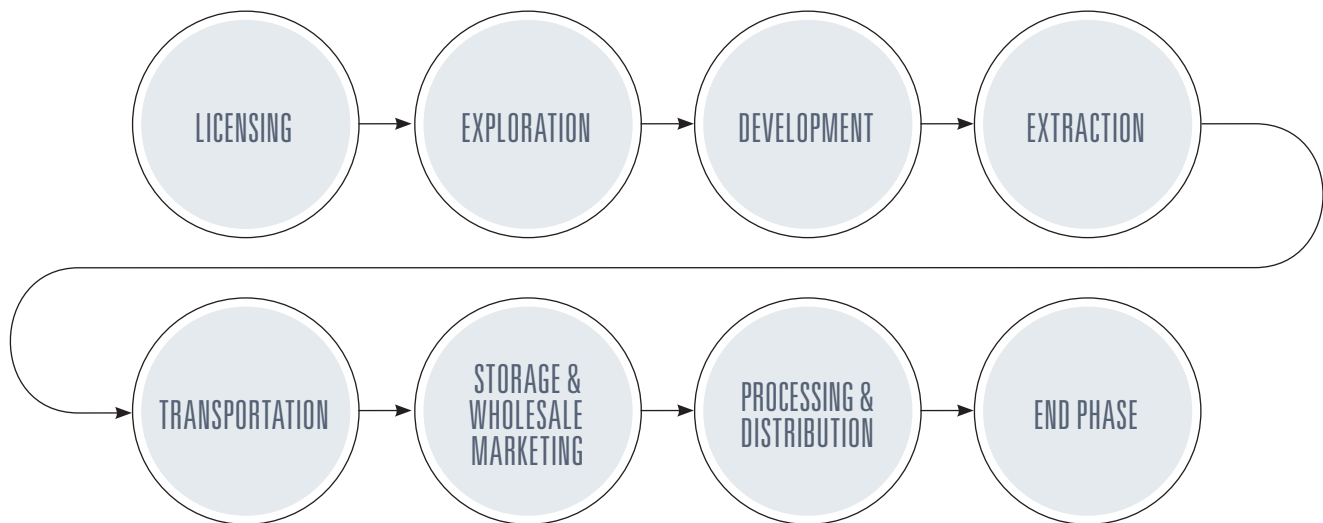


TYPES OF ILLICIT FINANCIAL FLOWS

	CORRUPTION	ILLEGAL EXPLOITATION	TAX EVASION	THIRD PARTY THEFT
DEFINITION	<i>The misuse of public authority for personal interest</i>	<i>Extraction and production of a resource without the consent of the legitimate government, outside the regulatory framework, or in violation of international law</i>	<i>The illegal non-payment or underpayment of taxes</i>	<i>Outright theft of resources or capital by a third party or offering of illegal services</i>
MAIN FINANCIAL FLOWS	<i>Facilitation payments (bribes) paid by companies, money embezzled from tax collection and budgetary allocation</i>	<i>Undeclared corporate revenues from illegal resource exploitation</i>	<i>Inflated costs deducted from taxable revenues, smuggling of resources, assets transferred to lower tax jurisdictions through transfer mispricing</i>	<i>Profits made from sale of stolen resources, stolen capital, profits from protection rackets and other forms of extortion</i>

Source: Le Billon, 2011; Author

Different phases of the hydrocarbon value chain are more or less vulnerable to different kinds of illicit flows. The hydrocarbon value chain can be divided into seven broad steps.¹¹²



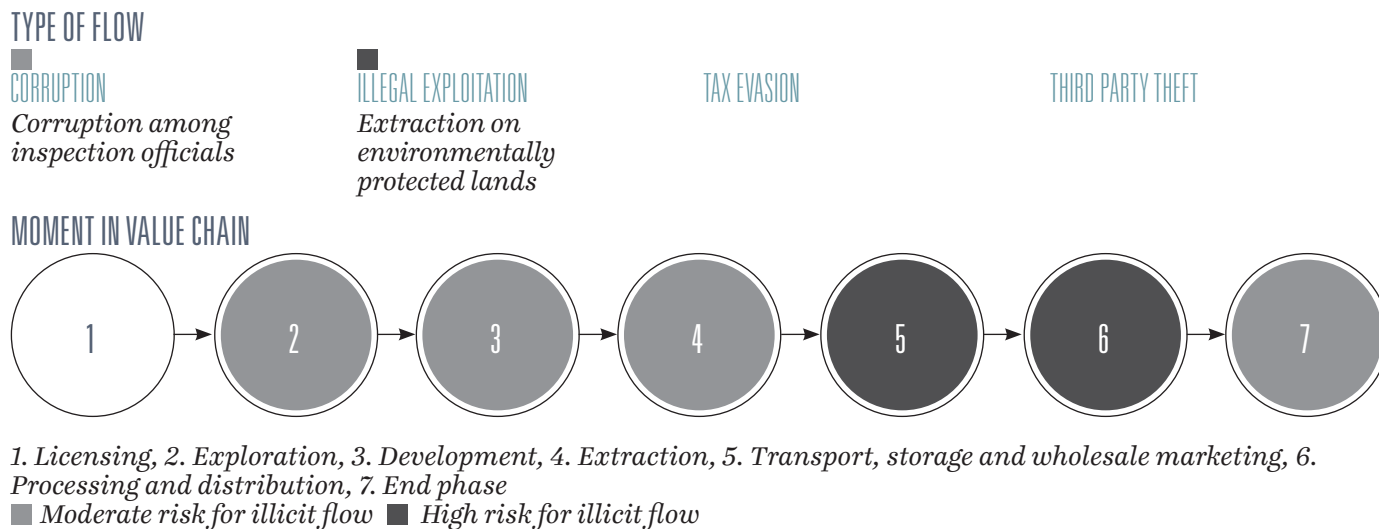
112. For a more detailed discussion see section two of the first section of this report, “The Global Hydrocarbon Industry”.

5.1 GAPS IN GOVERNMENT OVERSIGHT OF THE HYDROCARBON INDUSTRY

Gaps in legislation, oversight capacity, and political will leave room for illicit flows. Gaps exist in the regulatory framework for the environment, affected communities and labor, administrative and technical oversight, public procurement, and anti-corruption.

5.1.1 ENVIRONMENT, COMMUNITY AND LABOR

RISK FOR ILICIT FLOWS IN MEXICO'S HYDROCARBON INDUSTRY DUE TO GAPS IN THE REGULATORY FRAMEWORK FOR ENVIRONMENT, COMMUNITIES AND LABOR



The environmental and labor oversight mechanisms for the Mexican hydrocarbon industry are highly decentralized. The SEMERNAT and the STPS are the line ministries in charge of regulating and overseeing compliance with environmental and labor laws. However, several other ministries and independent government offices have regulatory, oversight, and sanctioning powers related to aspects of environmental and labor protection. The 2013 Energy Reform has exacerbated the decentralization of oversight. The reform creates ANSIPA, a new independent oversight body under SEMERNAT. ANSIPA is mandated to oversee environmental protection in the hydrocarbon

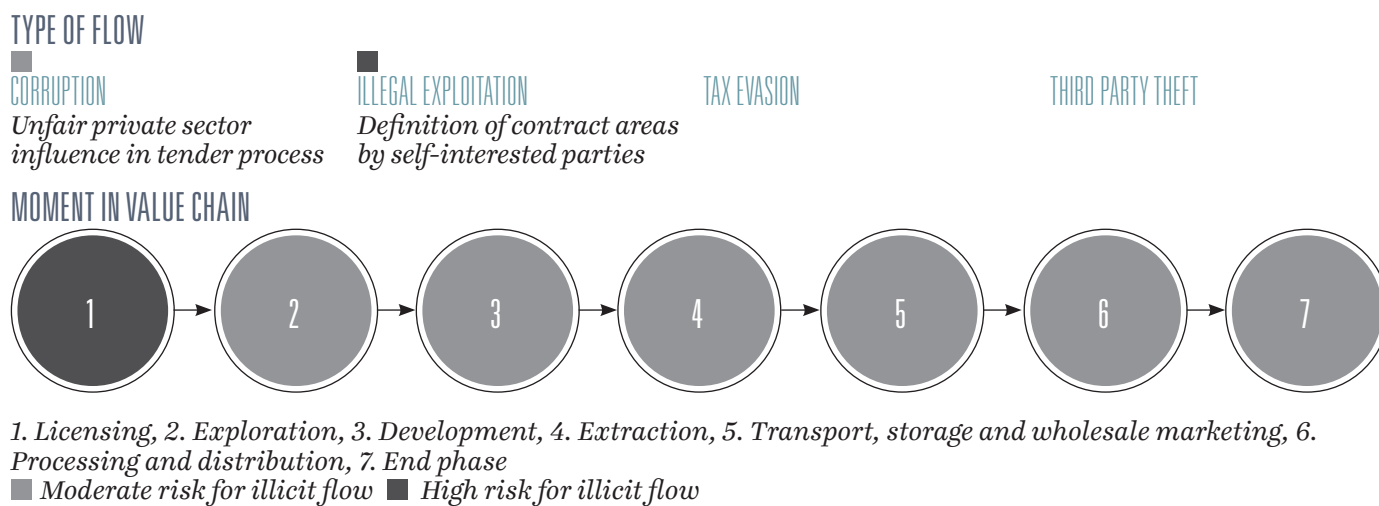


industry. However, the new laws do not specify that the oversight bodies that preceded ANSIPA should cede any responsibilities to the new agency. This leaves room for further overlapping powers. Redundancy weakens oversight and creates opportunities for corruption. There is less political incentive for responsible parties to enforce regulation because they can pass the blame should anything go wrong. Conversely, centralized authority improves transparency and accountability.

Additionally, there is lack of political will for environmental, labor, and community protection in the hydrocarbon sector. The Mexican Government prioritizes production and profit over all else. The board of Pemex currently only has representation from ministries related to income and production and no representation from ministries related to the environment, social development, or labor. This prioritization is further reflected in the language of the reforms to the Hydrocarbon Law (Ley de Hidrocarburos), an element of the secondary legislative reform enacted to implement the bill.¹¹⁵ There is no mention of land reserved for environmental or cultural reasons. This lack of political will make it less likely that exiting environmental, labor, and community protection legislation will be enforced and that corrupt actors will be prosecuted.

5.1.2 ADMINISTRATIVE AND TECHNICAL

RISK FOR ILLICIT FLOWS IN MEXICO'S HYDROCARBON INDUSTRY DUE TO GAPS IN ADMINISTRATIVE AND TECHNICAL OVERSIGHT



113. See *supra* note 96.

Under the pre-reform framework, both the CNH and CRE have the legal right to sanction Pemex and private sector actors in the hydrocarbon industry. However, neither agency has a strong track record of using this sanctioning power.

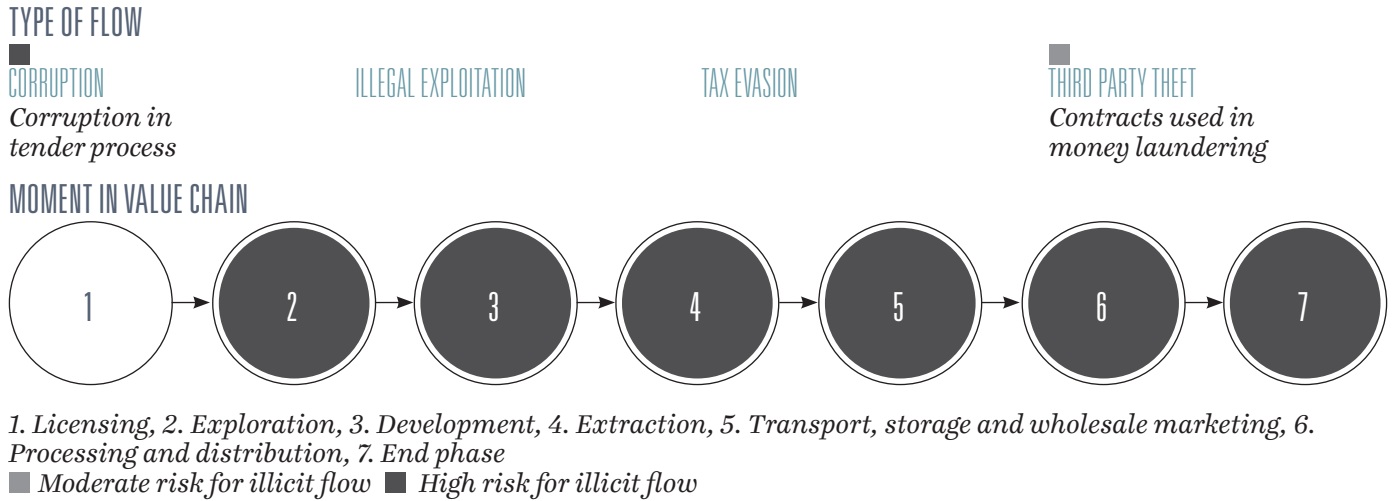
The framework envisioned in the 2013 Energy Reform relies heavily on the oversight capabilities of the CNH and CRE. They are responsible for administering the competitive bidding process, selecting winning bids, signing of contracts with Pemex and private companies, providing technical oversight of the awarded contracts, and ensuring efficiency. In this way, they will be the government agencies directly responsible for holding IOCs accountable, and IOCs are among the most powerful and well-funded actors in the world. This is a challenge even for the best-prepared regulatory bodies. As they stand, the CNH and CRE lack authority, experience, and expertise to fulfill this role. Moreover, the Mexican government does not have a strong track record of creating powerful, uncorrupt oversight agencies.

In the coming years, the CNH and CRE must demonstrate their ability to use their oversight and sanctioning powers. Additionally, internal and external anti-corruption mechanisms for the agencies must be developed and their effectiveness demonstrated. There must be good reason to believe that the CNH and CRE are more effective and less corrupt than past Mexican regulators. If these developments fail to take place, any moment of the licensing process where the CNH and CRE have unchecked discretion could be a source of an illicit flow.



5.1.3 PUBLIC PROCUREMENT

RISK FOR ILLICIT FLOWS IN MEXICO'S HYDROCARBON INDUSTRY DUE TO GAPS IN GOVERNMENT OVERSIGHT OF PUBLIC PROCUREMENT



The public procurement process represents one of the primary financial exchanges between public and private sectors. In selecting private firms for public contracts, individual government actors transfer billions of taxpayer dollars to the private sector in exchange for goods and services. There are an endless number of ways to manipulate these flows through corruption. The current Mexican procurement oversight system, which until the 2013 Energy Reform extended to Pemex, does not have the capacity to monitor every public contract. Approximately 30 public witnesses (testigos publicos), under the SFP, oversee the over 100,000 contracts signed each year.

The implementation of a 100% digital bid-tender process through Compranet helps transparentize the system and limits the most direct and obvious forms of corruption. However, the process can still easily be manipulated. For example, the terms of a contract can be designed with a particular company in mind or changed to favor a particular company during required “clarification meetings” (juntas de aclaración). The bid-tender process can be circumvented and contracts may be directly awarded for a number of reasons. Though justifications for direct awards are published on Compranet, there is little vigilance.



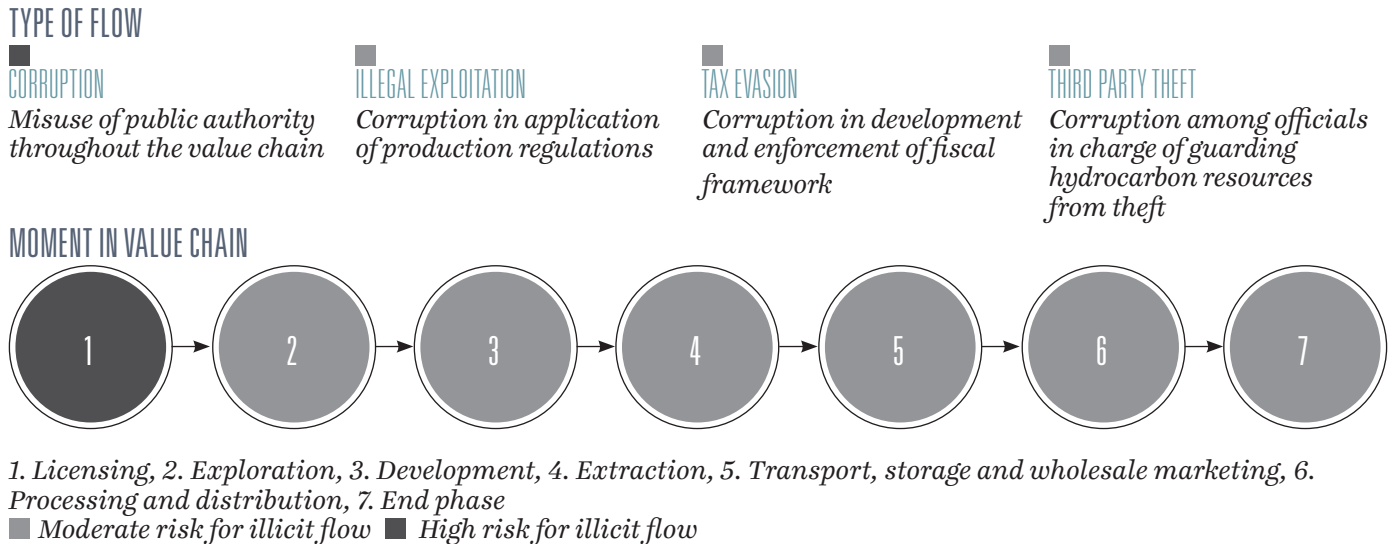
One of the most common forms of fraud in the public procurement process is non-delivery after the bid is awarded. Companies that do not deliver the promised goods and services may be sanctioned. However, sanctions tend to be small compared to the amount of money lost by the state and there is no straightforward way to search on Compranet which companies have been sanctioned in the past. There is a strong precedent in Mexico of awarding contracts to companies with a negative track record, a clear sign of corruption in the award process.

With the 2013 Energy Reform, Pemex's public procurement process will look more like the internal contracting process of a private company. Pemex will be responsible for overseeing and carrying out its public procurement process internally, with external oversight from government regulators. The implementing laws create a Committee on Acquisitions, Leasing, Works and Services under the Pemex Board of Directors. However, internal oversight committees have done little to improve Pemex's performance in the past.

Pemex is a highly entrenched company with strong cultural and political ties across Mexico. The legislation transforming Pemex into a productive state enterprise does not erase that. It remains to be seen if Pemex's public procurement process can be made less corrupt through market competition, or if weakening government oversight of the process will make it more corrupt.

5.1.4 ANTI-CORRUPTION

RISK FOR ILLICIT FLOWS IN MEXICO'S HYDROCARBON INDUSTRY DUE TO GAPS IN THE ANTI-CORRUPTION FRAMEWORK



The Mexican anti-corruption oversight framework is decentralized, has significant gaps due to incomplete reforms, and suffered from lack of political will for further reform. A complex bureaucracy and lots of red tape make it ineffective and slow acting.

In his first speech as president-elect, Peña Nieto promised anti-corruption reform. On November 15, 2012, President Peña Nieto's anti-corruption reform was formally delivered to the Senate. The proposed reform included the creation of an autonomous anti-corruption commission to replace the SFP.¹¹⁴ The SFP has long been considered an ineffective ministry and Peña Nieto was not the first president to propose its elimination. In 2009, President Calderón made the same proposal (along with the elimination of the ministries of agrarian reform and tourism), but he never managed to push his reform through the legislative branch. President Peña Nieto's reform envisioned replacing the SFP with an anti-corruption commission

114. Jaime Contreras Salcedo, "Llega Iniciativa de Peña Nieto Al Senado," *Excélsior*, November 15, 2012, www.excelsior.com.mx/2012/11/15/nacional/869960.



that would be an autonomous body with oversight of all three branches (legislative, executive, and judicial) and three levels (municipal, state and federal) of government.

Commissioners would have seven year terms, longer than the six-year Mexican presidency, giving them political autonomy.¹¹⁵ However, politics have made the creation of the commission complicated.¹¹⁶ More than a year after the reform was presented, on December 13, 2013, the Senate approved the creation of an anti-corruption commission.¹¹⁷ However, the final version of the law left out the anti-corruption commission, providing for an Anti-Corruption Coordinating Committee instead (see section 2.6.2 The Anti-corruption Mechanisms).

Another important element of President Peña Nieto's anti-corruption reform was the creation of the anti-corruption prosecutor's office. The Attorney General's office officially created the prosecutor's office, which has the right to press criminal charges for corruption, in March 2014.¹¹⁸ However, at the time of writing, the Senate had yet to designate the head of the office. Therefore, though in contrast to the anticorruption commission, the body has been created, it is not in operation and will remain headless and budget-less until the Senate acts. These gaps in anti-corruption oversight leave room for illicit flows throughout the Mexican Government, including within Pemex.

115. Armando Estrop, "Anticorrupción: La Trampa de Peña Nieto," *Reporte Indigo*, November 11, 2012, www.reporteindigo.com/reportes/mexico/anticorrupcion-la-trampa-de-pena-nieto.

116. Peña wanted to give the power to appoint the board members of the new commission to the Executive (himself), with Senate approval. The Senate did not want this because the PRI, Peña's party, had a near majority in Senate, so Peña would be able to appoint whomever he wanted with just a few additional non-PRI votes. The version finally approved gives the Senate the right to appoint the board members, with a presidential veto.

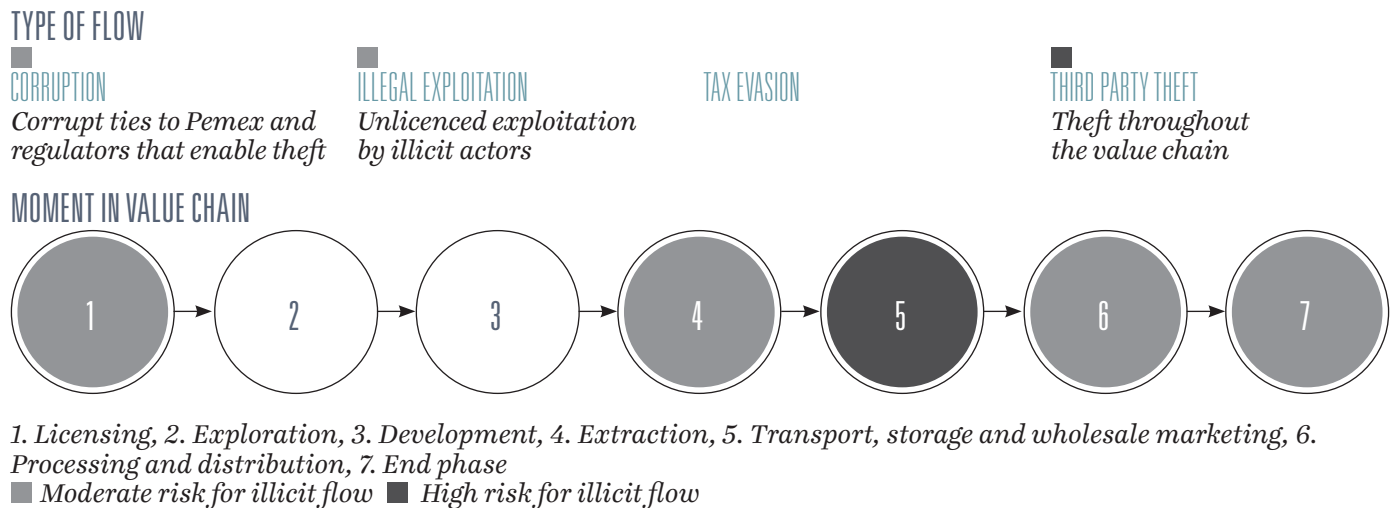
117. Mauricio Torres, "Tras Un Año de Desacuerdos, El Senado Avala La Comisión Anticorrupción," *CNN Mexico*, December 13, 2013, sec. Nacional, [mexico.cnn.com/nacional/2013/](http://mexico.cnn.com/nacional/2013/12/13/tras-un-ano-de-desacuerdos-el-senado-avala-la-comision-anticorrupcion)

12/13/tras-un-ano-de-desacuerdos-el-senado-avala-la-comision-anticorrupcion.

118. Diario Oficial de La Federación, *ACUERDO A/011/14 Por el Que Se Crea la Fiscalía Especializada en Materia de Delitos Relacionados con Hechos de Corrupción Y Se Establecen Sus Atribuciones*, March 12, 2014, www.dof.gob.mx/nota_detalle.php?codigo=5336635&fecha=12/03/2014.

5.2 THIRD-PARTY THEFT

RISK FOR ILLICIT FLOWS IN MEXICO'S HYDROCARBON INDUSTRY DUE TO THIRD-PARTY THEFT



The primary actors in third party theft can range from individuals acting independently to powerful, sophisticated organized crime networks. As discussed in section 4.3 Organized Crime, third party theft is a growing problem for Pemex. With the entrance of drug cartels, theft has gone from sporadic to systematic. Organized crime groups, through intimidation and corrupt links to Pemex workers, politicians, and law enforcement agents, are able to steal and commercialize a wider range of oil bi-products on a greater scale.

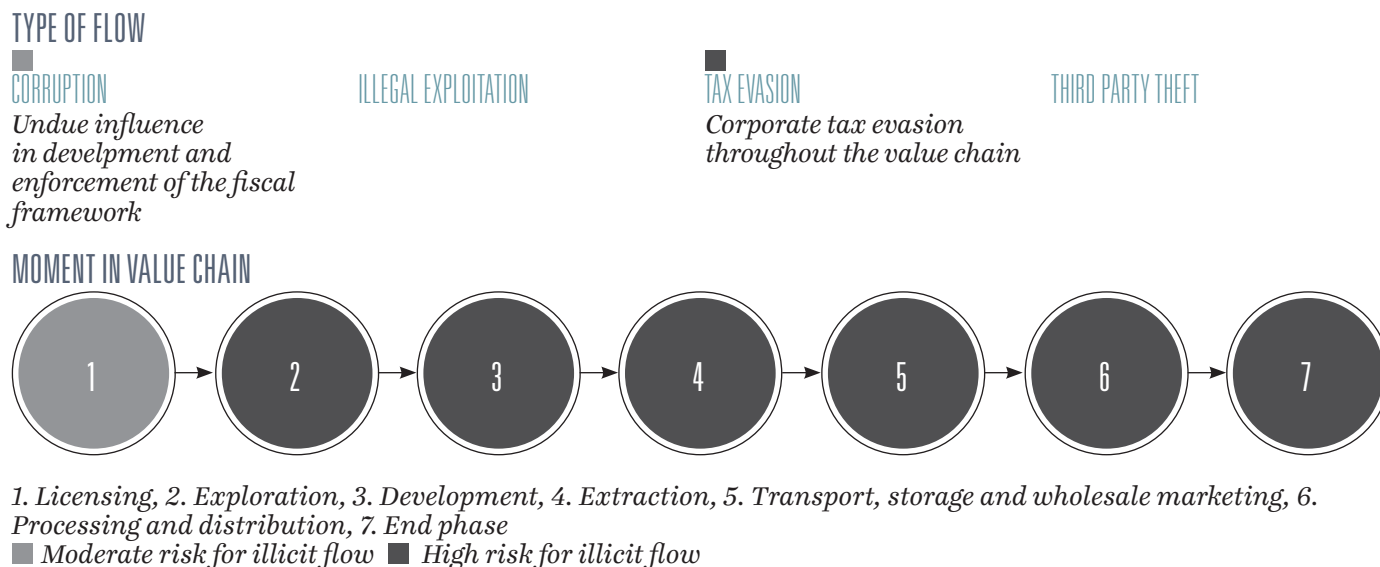
Large E&P companies are most vulnerable to resource theft in the form of siphoning during step 5: transportation, storage and wholesale marketing. Theft is also possible but requires a more sophisticated criminal infrastructure during steps 4: extraction, and 6: processing and distribution.

Small companies providing goods and services to the hydrocarbon industry are vulnerable to theft in the form of extortion throughout the value chain. There is a precedent in Mexico of theft during step 1: licensing, in the form of fabricated licenses.



5.3 TAX EVASION

RISK FOR ILLICIT FLOWS IN MEXICO'S HYDROCARBON INDUSTRY DUE TO TAX EVASION



With the 2013 Energy Reform and the entrance of IOCs into the Mexican economy, tax evasion will likely become one of the largest illicit financial flows in the Mexican hydrocarbon industry. Taxes levied by the Mexican government are collected by the SHCP and transferred to the national treasury. The international nature of the hydrocarbon industry as well as the power and influence of private sector actors exacerbate the problem. Large IOCs have ample experience and opportunity for tax evasion. Because they operate across many different countries, IOCs and international oil services companies can use transfer mispricing to move their earnings to lower tax jurisdictions.¹¹⁹ Additionally, private companies can inflate costs or under-report earnings to avoid taxes. There are opportunities for cost inflation, earnings under-reporting and transfer mispricing during steps 2 through 6: exploration; development; extraction; transport, storage and wholesale marketing; and processing and distribution. During step 7, the closing of oil fields, known as the end phase, companies may exit the investment before covering the costs of environmental cleanup and associated taxes. In extreme cases, companies may even enter into false bankruptcy to avoid these costs. Taxes may be avoided during step 1, licensing, by using corruption to write overly generous tax exemptions into the terms of contracts.

119. For more detail, see: *Theoretical Framework for Illicit Financial Flows in the Extractive Sector* section 4.3.3 “Misreporting and Transfer Mispricing.”

6. CONCLUSION

The goal of this report is to develop and apply a framework to analyze oversight and financial flows within the Mexican hydrocarbon industry. The framework is designed to be systematic and logical enough to help ordinary citizens understand an industry that directly affects their lives, while also flexible enough to take into account the complexity of the industry. The majority of the information synthesized in this report is public. However, the breadth and depth of analysis go beyond a simple industry summary. The report integrates an analysis of the private sector, public sector, community, and illicit actors and an understanding of economic, political, and social incentives to arrive at a comprehensive understanding of the industry, bringing attention to gaps in oversight and opportunities for illicit flows.

7. FURTHER READING

The Mexican government publishes its own analysis of the 2013 Energy Reform available at: www.presidencia.gob.mx/reformaenergetica/. Mexican government information and analysis of Round Zero can be found at www.energia.gob.mx/webSener/rondacero/index.html and of Round One at energia.gob.mx/webSener/rondauno. Detailed information on the Round One tender process is available at www.ronda1.gob.mx/seguimiento.html. Mexican government statistics in tax revenue are available through the SHCP website. Mexican government statistics on Pemex expenditure and revenue are available through the Pemex investor relations website.

A number of international think tanks and advocacy groups have published useful reports on oversight, tax, fraud and illicit flows in Mexico. The World Justice Project's Rule of Law Index is among the most robust indices of its kind. The 2014 report, which includes an analysis of Mexico, is available at: worldjusticeproject.org/sites/default/files/files/wjp_rule_of_law_index_2014_report.pdf.

Global Financial Integrity has published well researched reports on illicit financial flows, macroeconomic imbalances and underground economies internationally, including a Mexico specific report available at: www.gfintegrity.org/report/mexico-illicit-financial-flows-macroeconomic-imbalances-and-the-underground-economy.

Similarly, Revenue Watch Institute publishes analysis on oversight structures of the extractive industry. Their analysis of Mexico is available at: www.transparency-initiative.org/wp-content/uploads/2012/12/TAIMexico1.pdf.



ANNEX I: LAWS CREATED OR REFORMED BY THE 2013 ENERGY REFORM

LAWS NEWLY CREATED:

- The Hydrocarbon Law (Ley de Hidrocarburos);
- The Electricity Industry Law (Ley de la Industria Eléctrica);
- Coordinated Regulatory Bodies Act on Energy (Ley de Órganos Reguladores Coordinados en materia energética);
- The PEMEX Law (Ley de Petróleos Mexicanos);
- Federal Electricity Commission Law (Ley de la Comisión Federal de Electricidad)ñ
- National Agency for Industrial Safety and Environmental Protection in the Hydrocarbon Sector Law (Ley de la Agencia Nacional de Seguridad Industrial y de Protección al Medio Ambiente del Sector Hidrocarburos);
- Geothermic Energy Law (Ley de Energía Geotérmica);
- Hydrocarbon Revenue Law (Ley de Ingresos sobre Hidrocarburos);
- Mexican Petroleum Fund for Stabilization and Development Law (Ley del Fondo Mexicano del Petróleo para la Estabilización y el Desarrollo).

LAWS REFORMED:

- Foreign Investment Law (Ley de Inversión Extranjera)
- Mining Law (Ley Minera)
- Ley de Asociaciones Público Privadas
- Ley Orgánica de la Administración Pública Federal
- Ley Federal de las Entidades Paraestatales
- Ley de Adquisiciones, Arrendamientos y Servicios del Sector Público
- Ley de Obras Públicas y Servicios relacionados con las Mismas
- Ley de Aguas Nacionales
- Ley Federal de Presupuesto y Responsabilidad Hacendaria
- Ley General de Deuda Pública
- Ley Federal de Derechos
- Ley de Coordinación Fiscal



ANNEX II: MEXICO'S PUBLIC SECTOR BUDGETARY REVENUES

MEXICO'S PUBLIC SECTOR BUDGETARY REVENUES (MILLIONS MXP)

	JANUARY- DECEMBER				JANUARY- NOVEMBER
	2010	2011	2012	2013	2014
TOTAL	2,960,443.0	3,271,080.1	3,514,529.5	3,803,661.7	3,543,030.9
OIL RELATED	973,038.2	1,101,879.1	1,183,895.3	1,261,048.9	1,099,360.8
● PEMEX	385,437.1	395,232.2	463,121.3	482,316.4	375,026.7
● Federal government	587,601.1	706,646.8	720,774.0	778,732.5	724,334.1
● Royalties to hydrocarbons	641,458.1	849,307.4	923,285.1	861,551.7	739,169.6
● Ordinary	554,098.1	738,238.3	789,057.8	736,376.7	621,445.3
● Extraordinary on crude petroleum export	6,644.0	24,151.9	19,594.2	10,313.2	5,745.5
● Stabilization Fund	77,071.3	81,246.6	106,150.8	106,401.3	103,940.8
● Scientific research and technological Fund on energy	3,615.7	5,635.2	8,440.8	8,421.7	8,001.0
● For the oil control	29.0	35.3	41.5	38.9	36.9
● Advantage on excessive yields	0.0	0.0	0.0	0.0	0.0
● Excise taxes (EIPS)	-56,153.3	-145,679.1	-203,084.3	-86,029.6	-19,364.2
● Article 2. Section I	-76,963.1	-165,977.3	-222,751.4	-105,287.5	-42,217.9
● Article 2. Section II	20,809.8	20,298.2	19,667.1	19,257.9	22,853.7
● Oil yields tax	2,296.3	3,018.5	573.2	3,210.4	4,528.7
OIL RELATED AS % TOTAL	32.87%	33.69%	33.69%	33.15%	31.03%
NON-OIL RELATED	1,987,404.8	2,169,201.1	2,330,634.3	2,542,612.8	2,443,670.1
● Federal government	1,492,411.9	1,613,594.9	1,731,759.8	1,924,462.4	1,852,781.1
● Tax	1,314,282.0	1,436,714.7	1,516,950.7	1,644,467.4	1,651,431.3
● Total Income Tax	679,621.9	759,167.8	803,896.7	946,505.7	869,675.5
● Income Tax	626,530.4	720,445.3	758,912.5	905,289.6	893,280.9
● Unique Rate Corporate Tax	45,069.2	47,164.5	42,198.8	47,204.3	-11,790.7
● Tax on cash deposits	8,022.2	-8,442.0	2,785.5	-5,988.2	-11,814.7
● VAT	504,509.3	537,142.5	579,987.5	556,802.8	609,396.2
● Excise taxes	60,617.1	69,245.6	72,952.9	78,572.4	113,615.2
● Import taxes	24,531.1	26,881.2	27,906.1	29,259.4	30,791.2
● Others	45,002.7	44,277.6	32,207.6	33,327.2	27,953.1
● Non-tax	178,129.9	176,880.2	214,809.0	279,994.9	201,349.8
● Rights	32,046.1	35,920.7	42,574.8	44,073.4	43,243.8
● Fees	141,902.0	136,299.8	166,002.3	227,846.9	152,987.8
● Others	4,181.8	4,659.6	6,232.0	8,074.6	5,118.2
● Public entities under direct budgetary control*	494,992.9	555,606.2	598,874.5	618,150.5	590,889.1
OIL RELATED AS % TOTAL	32.87%	33.69%	33.69%	33.15%	31.03%

* This includes the CFE, LFC, IMSS, and ISSTE

Source: "Finanzas Públicas," Secretaría de Hacienda y Crédito Público. Accessed January 27, 2015. To access, visit SHCP's "Estadísticas Oportunas de Finanzas" page and select "Reportes" > "Ingresos, gastos y financiamiento del sector público" > "Ingresos Presupuestarios" > "Ingresos Presupuestarios del Sector Público" www.shcp.gob.mx/POLITICAFINANCIERA/FINANZASPUBLICAS/Estadisticas_Oportunas_Finanzas_Publicas/Paginas/unica2.aspx

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