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## Powering up: Latin America's energy challenges: the Mexican oil reform: before and after

### Report

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# The Mexican Oil Reform: Before and After<sup>1</sup>

**A** former director general of Petroleos Mexicanos (Pemex), Adrian Lajous, identified five issues and challenges that would greatly affect Mexico's position in the oil world. They included:

1. The exhaustion of Mexico's expansive cycle of petroleum production, which occurred between 1995 and 2004 and has since declined. It could only be moderated through great effort in the future;
2. The continuing reduction of proven reserves, the extracted deposits accounting for 70 percent of the total, the improbability of discovering an amount comparable to them in the southeast basin as occurred in the late 1970s and early 1980s, and the likelihood of current reserves lasting for less than ten years on average if current volumes of production are sustained;
3. The conversion of Mexico into a substantial importer of oil products, in particular petrol, gas and natural gas, with the volume in 2009 equivalent to 40 percent of domestic gasoline sales, an eighth of natural gas and more than a quarter of liquid gas (LG);
4. A shift in the oil market from a buyers' to a sellers' one, which has brought a considerable rise in prices and inevitable volatility; and
5. The resurgence and intensification of concern with the security and supply of oil and natural gas in oil-consuming countries, aided by factors as diverse as they are ubiquitous.

Together these trends presume a radical transformation in Mexico's involvement in the global oil system and change in Mexico's economy and oil sector. In the best-case scenario, from being an important exporter, the country's influence will decline over a more or less long period. In addition, it is important to consider the concentrated nature of crude oil exports in a single market: in 2009 90 percent of Mexican sales were to the US, which constituted 11 percent of its total imports. It would be extremely difficult for Mexico to replace the US with other markets at a time when the US is not critically dependent on Mexican supplies. However, these are considered among the most reliable and Mexico is seen as a trusted supplier, which during uncertain times creates strong links and whose change would be costly. On the other hand,



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<sup>1</sup> Translated from Spanish by Guy Burton and Karla Ruth Orozco Toledano

this concentration reduces Mexico's presence and influence in the global hydrocarbons market. Diversifying Mexican exports of crude oil has been and is a much easier proposal to suggest than to carry out in practice.

The limits to exports could contribute to prioritisation of supplies on national security grounds. If the volume of exports are limited by a requirement which ensures a sufficient amount of reserves to meet predicted national demand over a reasonable time, perhaps 25 years, it would generate a strong stimulus for exploration – which has not been present during the ten year period of growing oil production and in which the average life of proven reserves has declined from 48.8 to 14.8 years and to less than 10 in 2009.

Oil and natural gas imports place the country as a buyer in the market for these products. It would appear that it has opted for those supplies that are closest and most easily accessible. Since the mid-2000s one can say that it has positioned itself better as an importing country, especially in the case of natural gas by exploiting the option of natural liquid gas (NLG) from various locations, including across the Pacific.

One may question the logic of, on the one hand, reaffirming Pemex's objective of achieving self-sufficiency in natural gas while at the same time announcing proposals to construct regasification plants to import low-cost NLG from the Pacific basin. One would have to determine if the costs incurred in investing in these plants would be justified as a one-off measure if self-sufficiency is reached.

Beyond this particular example, it seems clear that it is necessary to revise and adjust the country's behaviour as a notable importer of petrol and natural gas. Would it be able to do so in the medium to long-term or could it design a rational and effective substitution policy for imports in the oil sector? Would it be possible to reduce the amount of imported supplies to Pemex with a national minimum scheme like that established by Petrobras? Key questions such as these were not addressed in the 2008 oil reform.

In the wide world of oil there occur phenomena both close and distant which may affect the Mexican position. Before the very important fluctuations in international prices in the second half of the 2000s, OPEC had regained influence and had returned to being a key actor

in the global oil market. What will be the nature and scope of Mexican cooperation with OPEC in its efforts to sustain the price of crude exports, which in the past Mexico has not only accompanied but at some times led? Now Mexico faces a clear quid pro quo: high prices for crude produce greater export income, but at the same time higher spending for oil imports whose prices move in relation to those of crude.

In this period of high nominal prices for crude in the global market, Mexico – more under the influence of the Finance Ministry than that of the Energy Ministry or Pemex – has insisted on all sorts of caveats and warnings that higher oil prices pose to monetary stability and global economic growth. Coming from an exporting country, such warnings may seem somewhat excessive as well as unrealistic. Over recent years we have analyzed the reasons for the rise in nominal oil prices, which unlike previous decades, has neither led to general inflationary pressures nor constrained global economic growth. The global crisis in 2008-09 may be attributed to various factors, but not to international oil prices.

## PEMEX AND ITS SISTERS

At the beginning of the 21st century, various studies about global oil usually distinguish between private transnational corporations (TNCs), known in their golden age as ‘the seven sisters’, and the state oil companies (SOCs). The latter’s relative importance has grown, as evident from their control over nearly four-fifths of global oil reserves. If Pemex had sisters they would be found among these companies.

From an international perspective, Pemex is commonly seen to have lost ground to other oil corporations, both private and public: as an integrated oil company – according to the official *Analysis* released in 2008 - Pemex is the eleventh largest in the world. However, this position has continually deteriorated in recent years: in 2000 Pemex was the sixth most important oil company; in 2004 the ninth, in 2006 the tenth and, in 2007, the eleventh.

This ranking allocates the following indicators to each company: oil reserves and production, natural gas reserves and production, refining capacity and the amounts produced and sold. Of the 50 most important companies at the end of 2006, 21 were private companies; five had minority participation from the public sector; six more had public majority involvement and the remaining 18 were completely public. If one takes only the twenty largest, 10 are state-owned, three more have public sector involvement and the remaining six are private. Between its sisters, the largest SOCs, Pemex occupied fifth place in 2006.

In terms of reserves, in 2006 Pemex occupied ninth place between the SOCs, above the SOCs of Algeria (Sonatrach), Malaysia (Petronas), Egypt (Egyptian General Petroleum Corporation) and Colombia (Ecopetrol), among others. It is usually considered that ownership of reserves translates into an ability to maintain production levels and influence in

determining prices. After noting that “currently the top ten reserve holders are state monopolies”, a 2007 study by Amy Mayers Jaffe and others at Rice University (*The International Oil Companies*), made the following observation:

“The disadvantage of TNCs in relation to SOCs in terms of possession of reserves has raised speculation about the former. The perspective of the TNCs – and the mergers between them – depends on their ability to develop gigantic oil and gas fields around the world. In recent years the leaders of the important oil producing countries, such as Russia, Venezuela and Saudi Arabia, have not favoured sharing the exploration and development of their resources with those of the TNCs, which have seen their access to large existing reserves become very restricted. In some cases, especially Venezuela and Russia, the TNCs have experienced renationalisation, which recall the 1970s. At the same time the SOCs have been at the front of not only recovering control of own territories’ resources and income, they are also exploring foreign fields, exceeding in some cases the TNCs in the development of such resources.”

Another recent study, prepared by Robert Pirog for the US Congress (*The Role of International Companies in the International Oil Market*), stresses the different objectives pursued by the public oil companies in relation to private ones. In many cases the first pursue “wealth redistribution, job creation, general economic development, economic and energy security, objectives that may be seen as desirable from the point of view of the national government”. However, the report suggests that “the United States government can use its political influence to encourage countries not to use their national oil to reach their governments’ objectives, but instead preferably favour commercial practices that maximise revenue streams. In some cases a large supply of oil could be used as a condition for commercial and assistance agreements.”

Against these international trends, the 2008 reform proposed that Pemex behave like a TNC and serve US interests rather than as a SOC and Mexican interests.

## THE REFORM AND ITS PURPOSE

The oil reform proposed in 2008 and approved with substantial changes the following year constituted a range of proposals designed to modify Pemex's organisation, the aim being to promote involvement from both domestic and foreign private actors in activities that the Constitution and law restrict to the Mexican state firm.

To provide a basis for the reform proposal, the Mexican government published the official *Analysis*, which had a descriptive focus and presented the situation for the organisation as a matter of fact and final. It would have been more useful if the document had been analytical and in addition to presenting reality, examined how and why it had arrived at this situation. Without this analysis it would seem that the deterioration in deposits, the fall in levels of production and reserves, the lack of refining capacity and other problems stressed in the document demonstrate imminent doom. As a result the conclusion is foregone: what is required is to allow "modern and effective measures of collaboration with third parties".

It is noted, for example, that "the hydrocarbon reserves have been diminishing since the mid-1980s", as if this decline could not be avoided or stopped, and assuming the continued fall in output of the basins in operation until 2021, "considering increases in recovery rates". No indication was given of their size, the volume of remaining crude deposits, or of the possibility of further increasing their use. Until this year Mexico has managed to obtain 1.8 million barrels per day. To replenish and maintain the level of 2008 production until 2021 would require making use of the "deep

Gulf of Mexico" deposits. Nowhere in the *Analysis* were assumptions about economic growth, domestic demand, or export and efficient energy performance made clear.

In fact, the official *Analysis* was overwhelmingly geared towards supporting the conclusion that "initiating the development of deep waters is essential" and of course, the already decided upon corollary: "Pemex may need to be accompanied by other companies to develop various activities with its own money", an expression that concealed the intention of the proposed privatisation reform.

The *Analysis* also stressed the growing dependence on foreign refining and expects that in 2015 Mexico would have to import "almost half" of demand and that in 2027 "imports would be more than twice the level of national production". Not stated are assumptions regarding growth of fuel demand, the effects of improved automobile efficiency, or the use of alternative energy sources. Again, the *Analysis* is only interested in presenting an obvious, simple conclusion: to increase refining capacity with private foreign investment. Following the reform's approval at the end of 2008 the aim of building a new refining plant, - the first in several decades - was announced with much fanfare. A year and a half later, the tendering process has not even begun. To all practical intent, the project has been forgotten.

Thus it is paradoxical that the *Analysis* postulates that "the challenge is to do this all at the same time: investment to increase transmission and storage capacity, reconfigure current refineries, to meet the challenge of cleaner fuel and the construction of new refineries". The only explanation to account

for the manner of such a challenge is to justify that Pemex requires “the support of third parties” to lay down pipelines; the Analysis notes “flexibility in contracts” and that Pemex can increase its refining capacity “with its own and complementary investment”. In addition, it recommends reducing dependence on foreign and imported gas and other oil products, replacing one form of external dependency, in the construction, operation, installation and maintenance of ducts, in favour of private ownership, most probably foreign.

When addressing “problematic finance”, the Analysis suggests that Pemex should use “more of its own resources and less debt” and to continue to attract “complementary investment” – that is to say, foreign resources, as if this could be obtained without any costs, as if these investments did not generate profit remittances and other returns. No estimate of their size is made.

The Analysis contains two indicators that are not related explicitly: first, the total taxes, rights and utilities paid by Pemex (676 billion pesos, equivalent to \$USD14.65 billion in 2007); and second, the size of oil rent, defined as the difference between the value of hydrocarbons extracted from the subsoil at international market prices less minus the cost of efficient extraction (509 million pesos, equivalent to \$USD11 million in the same year). The latter remains with the state while taking away in addition 32.8 percent from the firm’s receipts, an unrecognised spoliation and in which a large part of the company’s financial problems may be found. For a long time Pemex has been subject to a clearly confiscatory tax regime, which has deprived the firm of investment, expansion and modernisation opportunities.

It has been stressed often that Pemex would benefit from greater autonomy. The Analysis reiterates this point. On the one hand, no one would be against more liberalisation for the company against the institutional and administrative ties that subject it to the federal budget and obsolete regulations concerning the operation of state organisations and firms. On the other hand, there is agreement that oil rents should not only be extracted from Pemex – which by definition, corresponds with the state – but additional sums too. Nevertheless, in the various debates and discussions around oil reform the question of managerial autonomy has acquired another character, becoming a double-edged sword.

The experience of the last three decades makes it evident that Pemex should be saved from the grip that is choking it: confiscatory tax and labyrinthine regulation that has subjected it to the government on one side and the maze of corruption in which it has been entangled by the unions, contractors and other “private” actors on the other. The abusive recourse to third parties harms the public interest and has served to benefit private firms, which are often the property of government officials. For this reason, the prospect of managerial autonomy for Pemex is disturbing. It could convert it into a vehicle for private interests that whether openly or discretely could appropriate oil rents and make use of them selectively.

## AFTER THE REFORM

Since the forced approval of the reform very little has happened. The introduction of a new Administration Council – with four professional and independent advisers – and the National Commission of Hydrocarbons awaits the end of their legal deadline. The CEO who introduced the reform was unceremoniously replaced. The project to build a new refinery has been largely abandoned. The deterioration in levels of production and crude exports has continued as has the rise in oil imports. After the reform, Pemex is, in almost every respect, in a worse position than before.

Perhaps this is why – with the support of oil companies or suppliers with which they will surely agree – all of Pemex’s substantial activities are now open to standard contracts that include private participation, going far beyond the provisions of the amended legislation. During the bill’s passage there had occurred a legislative debate about the legality of such contracts.

Bearing in mind these contracts, an official campaign has begun to attract investment and to encourage the involvement of private companies – above all foreign ones – in Pemex’s activities. During the Mexican president’s official visit to Japan at the start of February 2010, Felipe Calderon spoke to businessmen, stressing the reform of the oil industry “extended the opportunities for investment with Pemex, through the use of much more flexible contracts, which will allow us to increase the production of oil and natural gas”. Other officials, such as the energy minister and economy minister have offered much more detail over the greater flexibility of contracts that Pemex plans to sign with private actors. ■