EXECUTIVE SUMMARY

For decades, Mexico’s needs for electricity and petroleum products have been managed by the state in all phases, from the generation of power to the pricing of the kilowatt-hour and from the exploration and extraction of oil to the price of gasoline at the pump. Critics of this policy framework claim that Mexico’s society and economy have paid a terrible price for this utopian vision. It has stifled innovation, restricted capital deployment, and left Mexico’s consumers at the mercy of international indexes for the pricing of their energy products.

In this issue brief, I will examine the signals—those in writing and otherwise—that are conveyed by the energy reform package that was promulgated on August 11, 2014. There are two areas of concern: theoretical and contractual. I want the energy reform to succeed—to surpass expectations—but I see limitations in law, institutional design, and policy that may delay, if not derail, its success.

INTRODUCTION:
MEXICO’S ENERGY NARRATIVE

Mexico’s energy narrative is a composite of sound economic and political theory and populist ideology. I detect four unspoken postulates:

1. Access to modern forms of energy is the portal to modern life. The unavailability of modern energy adversely affects all aspects of family and community life: public health, nutrition, education, innovation, the environment and, taken together, local, regional, and national economic development.

2. Because of its central function in civilized life, energy must be considered a public good—that is, in the sense as used by economists to refer to those aspects of societal life that are inherently communal, such as the right to walk on the sidewalk of a street or the use of air to breathe.

3. According to Mexico’s narrative, it follows that those government agencies that administer these public goods are to be considered public goods in themselves. This is the logic behind the often-heard declaration by Mexico’s politicians that “Pemex will not be privatized, as it is the property of all Mexicans.” Said differently, Pemex, as a public good, cannot be redefined as a commercial entity subject to private interests. The same logic applies with greater force to the Comision Federal de Electricidad (CFE).

4. Derived from these postulates is the conclusion that private industry has no place as an economic actor in Mexico’s power or oil sectors, given that its interests are independent of those associated with the general welfare of the public.
Mexico’s energy reforms of 2014, as demonstrated below, seek to modify this narrative only at the margins.

**BACKGROUND**

Mexico’s long, ambivalent relationship with the international oil industry goes back more than a century. The historical record shows that it was thanks to a radical reform of the legal system toward the end of the 19th century conferring mineral rights to surface owners that the first oil boom of the first decades of the 20th century took place. The British and American entrepreneurs who deployed capital to explore, extract, transport, refine, and distribute oil and refined products laid the foundation of Mexico’s oil industry. It was the government’s pro-market, pro-investment policy that brought modern forms of energy to Mexico, beginning with lamp oil for street lighting.

It was the partial reversal of that policy that set in motion a backlash against the oil companies. Technically, the reversal was set forth in Article 27 of the Constitution of 1917: henceforth, it would be the state, not the surface owners, who owned the mineral rights. As radical as this change sounded, in practice it could have meant little to the oil companies had they realized that the government’s offer of long-term licenses (as long as 50 years) corresponded to the expected life—and then some—of any given oil reservoir. You could say that what Article 27 took away with one hand government regulations would give back with the other.

But events did not unfold with any such equanimity. On the contrary, the two decades after 1917 would be the scenes of political, labor, and rhetorical skirmishes as the oil companies tried—needlessly—to claim that their properties were grandfathered, and thus exempt, from Article 27.

The expropriation of the assets of the oil companies in 1938 ended one argument—and started another. The new argument was about how Mexico would continue to need investment by oil companies as licensees of the state. The Petroleum Act of 1940 set forth the very framework that, 73 years later, would be invoked by the administration of President Enrique Peña Nieto to justify the upstream theory of the reform that would be promulgated in 2014.

During the tenure of Jaime J. Bermúdez as director general of Pemex (1946–58) fewer than a dozen exploration contracts were issued to a handful of small American oil companies. When Bermúdez refused to deliver copies of the contracts to Mexico’s Senate, on the grounds that a commercial agreement corresponded to the exclusive competency of the executive branch, an ugly political fight ensued in which the very patriotism of the Pemex director general was called into question.

As if to take revenge, the congress enacted the Petroleum Act of 1958, which was published on the last working day of the presidential term (November 29). The new law abrogated the Act of 1940, and restricted all contracts to ones that would exclusively be administered by Pemex but with the fatal restriction that compensation could not be in kind or measured by any percentage.

For 55 years, from 1958–2013, until it was abrogated in 2014—in effect, declared unconstitutional—the executive branch was given no flexibility in the awarding of exploration licenses for oil and gas. During this long period, Mexico’s energy sector survived as in a closed pressure vessel. The state sealed off market pressures from the outside. In all this time, on neither the oil nor power sides of the street, were there politicians, academics, or popular movements that called for taking the cap off the top of the vessel.

Insidiously, the root notion of the marketplace—competition—was contaminated through the introduction of international indexes to compare price and performance. The government says that it wants “competitive” prices, and Pemex promotes an image of itself as “competitive”—but only by virtue of indexes that show, comparatively, one metric of its operational or financial performance compared to the same metric in a half–dozen other companies that operate outside of Mexico.

**DISCUSSION**

The motivation of the 2014 energy reform was to return to the state the long overdue
flexibility to devise laws and policies that could respond to new technologies, business models, and geological and market opportunities.

Its architecture is of a kind never contemplated in the Petroleum Act of 1940. In the first place, it includes a restructured government agency created by law to serve as the administrator of exploration and production contracts. The mandate of this agency, which had been created by the Energy Reform of 2008, was expanded to include regulatory supervision of all upstream operators. The Hydrocarbon Commission (CNH) now has the responsibility for the design, administration and award of public auctions for exploration and production blocks. In addition, initially (in the so-called Round Zero) it will be responsible for choosing the companies that Pemex might have as business partners in any farm-out (or sub-contracting) of blocks to which it has been allotted.

Also new to the upstream scene is a National Petroleum Fund and a Hydrocarbon Safety Agency. Pemex and CFE are restructured into a new legal entity, the dimensions of which are not yet fully known. Both agencies are being restructured.

Pemex is to return to its corporate structure that was in place before 1992 in which there were two business units: one for the upstream, the other for the midstream and downstream. Additionally, Pemex’s pipeline division is being placed under the ownership and authority of a species of independent system operator.1 Corporate governance is to change also, with a new board on which union membership has been eliminated in Pemex and reduced in CFE and with the addition of part-time board members.

On the power side, CFE’s dispatching unit, Centro Nacional de Control de Energía Centro Nacional de Control de Energía (CENACE), will be set up also as an independent system operator, a measure that will also increase efficiency.2

Carried over from the ancien régime are several problematic elements:

Regulated Pricing of Energy Products
The government speaks frequently of the need to “lower energy prices” for Mexican families, but analysts observe that without the current level of government subsidies prices could rise. An invisible cost to society has been in the coin of missing signals that would come from a secondary market in gas pipeline capacity. The absence of such signals has resulted in a lost decade of pipeline construction.3 A second invisible cost is the system of penalties for under- and over-usage of gas and power: industrial customers could not freely buy or sell gas or power among themselves. The CFE is taking a leadership role in proposing a system of electronic bulletin boards that will eliminate this cost to society on the power side.4

Posting of Reserves
As a convention driven more by ideology than by geology or global practices, in Mexico it has been only the State that posts oil and gas reserves. The annual reserve disclosure by Pemex is entitled “The Petroleum Reserves of Mexico.” What seems likely is that the government is positioning itself to preserve this convention by restricting contractors to posting the net current value or some other non-volumetric measure of their discoveries in Mexico, thus allowing the state to be the only source that publishes the oil and gas reserves of Mexico.

Risk Exposure of Energy–Sector Government Employees
Employees in the federal government are subject to the Federal Employee Accountability Act of 1982 (LFRSP), which makes any employee personally liable in either civil or criminal court for damages that may occur on account of an act or omission on his part.

Observers regard the application of this law to employees and regulators in the energy sector as particularly unhelpful. It distracts employees from making business and regulatory decisions on the merits of the facts (simultaneously, employees will consider the strength of the deniability of any hypothetical accusation of wrong-doing).

Biddable Variable
One area where the toxic effect of the LFRSP may be seen is in the long tradition of awarding contracts on the basis of the lowest (nominal) price among the

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bidders. Pemex and CFE careerists are fully aware that the lowest, nominal price is not a guarantee of the lowest, life–cycle cost or the best value for the company or the state; yet, in contracts that are issued, such is the general practice, as the lowest price offers the best LFRSP alibi.

Pemex, CFE, and the state need to make awards on the best, life–cycle value, not on the lowest price. However, the tradition of lowest price is so well (and perversely) established that, short of forward–looking leadership in the finance and energy ministries, it will be continued in future auctions.

Deemed Price of Production
In upstream contracts that Pemex has issued since 2011 the deemed price of production of oil and gas has been established in the contract. Observers are concerned that while this mechanism may have worked in contracts in which the contractor was a pure service provider, it will not work in future contracts in which the contract–operator (or licensee) has explicit commercial interest in production of profits from production.

On the contrary, the operator of a field must be given the commercial freedom to find the best price for his share of production. Only in this way will there be an incentive for the contractor to make investments in new infrastructure.5

Presidential Discretion in Appointments
The directors general of Pemex and CFE carry out their responsibilities as the voice of the government policy in matters of oil and power, respectively, with the thinnest of assurances of job tenure. With just two exceptions since the 1950s, no director general in either company has served beyond one presidential term.6 By virtue of Article 47 of the Pemex law and Article 46 of the CFE law, the services of the director general may be terminated, discretionaly, by the executive or the board of directors.7

Critics observe that sketchy job qualifications, coupled with full presidential discretion in appointment and removal, militate against anyone in this position exercising business leadership. As a corollary, it means that the development of investment and commercial strategies is likely not to include input from the director general.

CONCLUSIONS
It is by no means clear that the implementation of the energy reforms of 2014 will lead to the emergence of energy markets. Rome was not built in a day, and much more will be learned in the regulations of the implementing legislation, and in the wisdom shown in the appointment of regulators, commissioners, and board members.

1. Natural gas: The government denies any interest in establishing a natural gas pricing hub inside Mexico,8 one that would be made possible by two measures: a) the existence of natural gas transportation pipelines that would compete with those of Pemex and CFE and b) allowing the new producers of natural gas to negotiate commercial terms with end–users inside Mexico (among them CFE, which is the country’s largest gas consumer).

2. Crude oil: For all of its history since the early 1970s, Pemex’s refining unit has acquired—or “bought” using transfer prices linked to international indexes—all its crude oil from Pemex’s upstream unit. What would happen if Pemex’s refining unit could buy crude oil directly from operators in Mexico other than Pemex? If companies that had either farm–out agreements with Pemex or contracts of one kind or another with the state were given commercial freedom to sell production to Pemex and CFE, then at some foreseeable point a market clearing price would emerge. Prices would reflect logistics, quality, deliverability, and anything else that could reasonably be put into the category of opportunity cost.

In order for pricing hubs—and, with them, competitive markets—to emerge, the government needs to allow producers to directly negotiate prices for energy products. In neither the legislation itself nor
in the official and off-the-record remarks of government officials is there a commitment to a market model based on price competition. If Pemex is to create an affiliate to sell cogenerated power to the market then CFE should consider creating an E&P affiliate that would have an equity interest with oil companies that would bid on gas-prone blocks in Round One and beyond.

Where price competition is to be allowed is in the abstract world of international public tenders where one bidder is to "compete" with another by virtue of his “prices” to acquire a block or to become a farm-in partner of Pemex or CFE contractor. In this sense, you could say that the government plans on having a system of market prices only for the several dozen (or even several hundred) companies who will participate in such public auctions. For everyone else, it’s business (that is, government pricing) as usual.

The government’s expectations that international investors will deploy investment capital in a non–market economy may be fulfilled by the oil and gas company and pipeline and power developer who are eager to have a project in Mexico. However, the economy will not receive the benefits of such investments until 1) all notions of deemed and indexed prices are eliminated from national energy policy and 2) the new economic actors are free to directly sell their share of production to Pemex, CFE or any other customer in Mexico or abroad.

To conclude, Mexico energy reforms of 2014 succeeded in giving the state the policy and contractual flexibility that it lacked. The challenge ahead is to exercise that flexibility in ways that respond to the needs and expectations of public and private stakeholders.

ENDNOTES

1. The benefits of increased “efficiency” are overrated if there is no competition. Industry’s recommendation to require Pemex Gas to divest its pipeline division had been in circulation for two decades.

2. The figure of a member of the board of Pemex who was not a public servant had been proposed early in the presidency of Vicente Fox, but the proposal was not pursued in the face of strong political opposition.

3. In February 2013 Pemex Gas paid US$22/MM BTU for LNG cargos delivered to Manzanillo at a time when the same million BTUs in Texas cost $4.


5. The government is also reintroducing a proxy for mineral–rights ownership for the surface owner. The latter may receive a percentage of the “profits” from production; practically speaking, such a benefit is best served on a “net proceeds” basis, where the landowner is given a share of the market value of the sale.

6. Francisco Rojas served in Pemex in two administrations; Alfredo Elías served in CFE in three.

7. As for qualifications, a director general is required to have a university degree in a profession related to the industry with no fewer than five years’ experience. In addition, he is to have at least ten years of experience in activities that would qualify him to be a board member.

8. Prices are net–backed from Henry Hub in Louisiana.