Mexican Energy Reforms: From Constitutional Reform to Completing Round 1.2

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Even as the international financial media declared the Round One, Phase One auction of oil properties a disaster, erstwhile technocrats in Mexico City were hanging tough. To hear them tell the story everything was under control; their learning curve was quite deliberate. But, old habits die hard, particularly the resort to command and control. It's just that command and control doesn't work very well when you're trying to open up a reasonably fresh market economy. Plus, there were other exogenous factors that were crucial, including, low world oil prices that have hit Mexico especially hard, and significant leakage in the retail gasoline trade, attributable to massive and systematic thievery by Mexico's criminal cartels. And, there is the matter of the precipitous decline of Mexico's once mighty petroleum state enterprise, Pemex (Petroleos Mexicanos). So while the technocrats remain optimistic a rough road remains ahead, and popular support of energy reforms is fraying.

Legislating Constitutional Reform

Constitutional reforms affecting the Mexican energy sector were passed in December 2013. Whereas the rest of the world, mainly developing countries, engaged in a long march toward nationalization of petroleum properties since the 1960s and 1970s, Mexico joined the few states that are reversing this trend.[1] Mexico nationalized its petroleum properties in 1938. The idea of *privatizing* the nation's natural resource patrimony is a major issue in Mexico and few nationals including the national government use the term privatization – but the duck is quacking and walking.[2] If not a massive privatization, Mexico has engaged in a major state reorganization toward open competition and re-regulation.[3]

The big change lies with Pemex, which controls vast holdings in the upstream, midstream and downstream operations. Pemex was re-organized and re-commissioned in August 2014 to become a highly regulated state enterprise with considerably less power, autonomy and responsibilities. While it would retain large holdings for the foreseeable future, it would in the medium term be in competition with private domestic and foreign interests i.e. off-shore in shallow-water deep-water territories of the Gulf of Mexico.[4] If Pemex does not produce on its exploration plans within the first 3-5 years, or sooner, such lands will revert to the Federal Government and presumably go up for auction to private interests.[5]

Why is this important? To date, Pemex has provided up to one-third of revenues going into federal coffers.[6] But its performance has faltered in recent decades: crude production is way down since 2004, given the drying up of the "super-giant" Cantarell field.[7] Pemex and other energy sectors have not kept up with technological change and a rising demand for top notch engineering expertise. Inappropriate subsidies, incompetence and corruption also add to the mix.[8] Mexico has suffered from the deeply sclerotic effects of the "resource curse."

And so in Mexico, state governing agencies have been inter-regulating on natural resource matters. The Ministry of Energy (Secretaria de Energia/Sener) designs contracts and "technical guidelines of public biddings" for Pemex and any private interests entering the petroleum field.[9] The Ministry of Finance (Hacienda) determines the "economic and fiscal terms," specifically taxation and royalty rates, et cetera. The regulator, Comision Nacional de Hidrocarburos/the National Hydrocarbons Commission (CNH) organizes the bidding for new petroleum contracts and any changes in land uses by Pemex. The Comision Reguladora de Energia/Energy Regulatory Commission (CRE) regulates storage permits, transportation and distribution through petroleum pipelines. In addition, there is the new Fondo del petroleo mexicano para la estabilizacion y el desarrolla/Petroleum Fund for Stabilization and Development, which receives, administers and distributes funds from designated natural resources beyond taxes owed.[10]

As Adrian Lajous remarks in an excellent economic analysis for the Columbia University Center on Global Energy Policy, Mexican energy reforms are hugely complicated, and will demand an army of technocrats to administer the new system. Even with outside consultants, the training arc will be extended well past current constitutional deadlines. This is a sobering assessment considering that Mexico's constitutional changes emerged from conditions of state failure.[11]

Round Zero

On August 13, 2014 the so-called "Round Zero" of changes for assigning properties to Pemex were announced.[12] Pemex was given the first shot at these properties. Mexico was moving to open competition, but Pemex was allowed to go to the ahead of the line. The corporation received titles to about two-thirds of what it requested i.e. "83% of the country's proven and probable reserves."[13] And, "[it] received 21% of Mexico's ... *potential* oil and gas reserves."[14]

Even with this protectionist posture by the Government, it still felt for many Mexicans that the gringos were again at the door, ready to scoop up their national patrimony -- a prospect feared by up to 40% of the population.[15]

Their anxieties were prescient. By the time declining oil prices were really kicking in, Pemex was suffering from declining revenues, making an already bad situation worse. The state corporation much admired, even revered by ordinary Mexicans, had to make a significant 11.5% budget cut in February 2015, which also impacted investments. A report stated in May that "Pemex [could not] guarantee that it has or will have sufficient resources to explore and extract the reserves that it was assigned. And as noted from constitutional provisions and secondary legislation Pemex could lose the right to extract those resources if it does not comply with the established exploration plan,"[16] Other difficulties hung over the corporation.

- "In the 1st quarter of 2015 the United States and Spain, two of Mexico's main export markets reduced their crude imports by11.6% and 43.1% respectively."[17]
- "At the end of June, Pemex suffered its 11th straight quarter in the red; the company reported US $5.2 billion lost in the second quarter of 2015."[18]
- "And, its average oil production declined 9.8% to 2.225 million barrels per day."[19]
- Mexico oil well drilling is in decline; "only 22 of 70 planned wells were completed in 2014, and only 2 of 8 are expected to be drilled" in the early period of 2015, January and February.[20]

- Pemex does not plan to replace 2000-3000 retiring workers in 2015; unfortunately this increases their pension liabilities by "nearly 32% from the end of 2013."[21] (Pemex is stuck with a collective agreement allowing retirement of its workers at 55 years with 25 years of service.)
- Finally, authorities granted a reprieve to Pemex precluding it from having to pay dividends to the Treasury in 2016. In 2014, Pemex paid the Treasury 50 billion Mexican pesos.[22]

Round One, Phase One

The Round One auction of oil leases began Dec. 11, 2014. It would be a convoluted process. Three elements made it difficult, as indicated, the orientation toward *command and control* by the governing agencies and *low quality properties* put up for auction in *shallow water acreages*. It also did not help that Pemex and other major internationals sat out the very first round.

There was a heavy emphasis on transparency by the technocrats; no one was going to accuse the Government of collusion or corruption during the auction. Indeed, the auction was broadcast on cable television on July 15, 2015. That transparency in the end caused a problem; technocrats were precluded from negotiating on price.

Without wishing to extend the drama, the auction was a wash-out. Only 2 of 14 acreages were completed in the transaction. Forty-nine participants began the process, 7 made a bid; two blocks of 7 with 14 properties were in the Round and there was effectively one winner, a medium size Mexican organized consortium, Sierra Oil & Gas, Talos Energy and Premier Oil. Transactions for all the rest of the properties were cancelled. The National Hydrocarbons Commission (CNH), the regulator, had predicted 30-50% of the properties would be leased, but in the end only 14% were taken up.

A fix would have been possible very quickly if Hacienda (the Finance Ministry) had not placed hard and fast minimums on most the blocks up for auction. Hacienda wanted the "minimum profit share for the government of 40 per cent for nine of the fourteen blocs; ... the remaining five blocks were set at 25 per cent"[23] Two bids fell just 5% below the minimum bid. If the government had taken them, literally negotiated on the spot, according to David Goldwyn of *Goldwyn Global Strategies* they would have sold 40% of the blocks and the government take for Blocks 3 & 4 would at least 50%. More importantly they would have made the 30-50% sales target.[24]

Other irksome inadequacies occurred. CNH failed to provide access to geologists in the "data room,"[25] and the seismic data was for the most part 2-dimensional -- based on Pemex's previous inadequate resources. Again, it was the problem of fastidious adherence to the rules of the auction, treating all participants exactly equal as part of the transparency initiative.

But a deeper problem was that CNH, Hacienda, and Sener were leasing undesirable properties; the properties were essentially Pemex's cast-offs from Round Zero, and they were in shallow water not the lucrative deep-water properties.[26]

It is not as if the technocrats at CNH were not learning on the job; there were lots of rule adjustments along the way on several items including recovery of costs, lessening restrictions on making bids, opening up the bidding rules for consortia making bids etc..[27] It was just that the less restrictive rules did not to attend the things that really mattered.

Round One, Phase Two

Phase Two was the obverse of Phase One in terms of adherence to disciplined rule-making. The orientation was towards compromise and flexibility with attendant good results. But not before some anxiety was expressed on the timing of succeeding Rounds. There were already Government rumours of delays in the deepwater and extra-heavy oil blocks back in the spring. By early September, *Energy Narrative*, a Boston-based newsletter, was reporting phase four (the deepwater and heavy oil auction) was postponed indefinitely. Sener (the oil and gas ministry) was fearful of market conditions and was in the middle of re-considering most appropriate licence contracts.[28]

Round One, Phase Two proceeded apace on May 25th when CNH announced the list of 26 interested parties. This time the majors joined the competition including Chevron, ExxonMobil, Royal Dutch Shell, Ecopetrol (Columbia), ENI (Italian), Noble Energy (U.S.), Petronas (Malaysia), Nexen Energy (China, Canada), and Pemex.

Phase Two involved "five production sharing agreements spread over 9 shallow-water oil blocks in an area already being developed by Pemex."[29] "The changes in Phase Two included adjustments to fiscal terms, a reduction in the cash guarantees, clarifications on contract risks, and new and lower minimum on profits going to the Government."[30] It was clear that Hacienda had backed off from its most onerous fiscal demands. Lourdes Melgar hydrocarbons Undersecretary in Sener stated: "I think it is important to send a message that Mexico is listening to industry concerns; ... market conditions have deteriorated and [they have] had a severe impact on oil companies, so we have to take that into account."[31]

These improvements made the round more appealing to medium-sized companies, "the independent firms who worked in the Gulf of Mexico and who could not afford the financial requirements in the first phase."[32]

Phase Two as expected captured significantly more support in the market place. On September 30th, CNH enabled winning bids for 3 of the 5 properties.[33] Sener Undersecretary Melgar pronounced himself pleased. "With numbers that we have assessed, we can expect peak production in the three fields, of at least 90,000 barrels per day."[34]

There are two additional auctions for Round One: "a mid-December auction of small onshore fields and a deepwater auction sometime in 2016" -- assuming everything goes well.[35]

Cartels Attack the Oil Industry

In an astonishing development, while the Government sought to bring in more and more multinational players through energy reforms, the criminal cartels were ramping up their attacks on the oil industry. Quite literally all over the country kidnappings, assassinations and other forms of violence were committed against industry employees.[36]

In addition, siphoning off of gasoline has become systematic and entrenched. According to a media investigation in 2014 "Mexican organized crime has created its own infrastructure to siphon oil off from pipelines, and transport it throughout Mexico and to the U.S., including use of its own fleet of tankers and boats in ports."[37]

This has led Pemex to resort to extraordinary measures. In February 2015, it announced it would "cease transporting fully refined gasoline and diesel fuel through its pipelines" to avoid illegal taps.[38] Pemex "documented 3,674 illegal taps in 2014, a 70% increase over 2013; in the first nine months of 2014 the company lost an estimated US $1.15 billion to oil theft." Pemex has plans to mix its fuel at 77 storage and distribution sites around the country, but the fear now is that the criminal organizations will move into the business of refining what they steal.[39]

Energy Narrative reports that "around 30% of the 200 million liters of gasoline and diesel sold daily are stolen, while the criminals make off with an estimated 360 million Mexican pesos."[40]This has forced Pemex to "ramp up gasoline imports and to boost domestic production at two major refineries after fuel shortages led to long lines at gas stations in several states in early July."[41] *Narrative* also reports "Mexico's Attorney General has identified 45 cells of 7 major drug cartels operating in the fuels theft business; ... organized crime has created a black hole of 7.5 million barrels in the transportation industry."[42] Criminal prosecutions are barely keeping up. *Narrative* again reports the same Att-Gen. "filed 14,500 cases for illegal taps, but to date (July 2015) only 2,185 or 15% have led to prosecutions and incarceration."[43]

Conclusion

In the wake of a steep learning curve in Round One, Phase One, the technocrats recovered, and made Phase Two success by adapting to the market. The majors joined in and gave their imprimatur on the project. For the future, the Mexican Government would do well to hasten the deepwater and heavy oil rounds; that's where the money is. Mexico desperately needs its coffers replenished, and Pemex will be hard-pressed to come to the rescue. Finally, criminal activity by the cartels quite obviously is undermining energy reforms. Somehow the Government must contain the corrosive influence of this nasty business or risk losing the initiative on the entire set of reforms.

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[1] See Michael L. Ross, *The Oil Curse: How Petroleum Wealth Shapes the Development of Nations*, Princeton: Princeton University Press, 2012, chapter 1.

[2] Adrian Lajous, "Mexican Energy Reform," *Center on Global Energy Policy, Columbia University*, June 2014, p.4. Lajous is a former CEO of Pemex (1994-99) and spent 29 years in the Mexican federal public service.

[3] On re-regulation, see Steven K. Vogel, *Freer Markets, More Rules*, Ithaca: Cornell University Press, 1996.

[4] See David Enriquez, “Mexico’s Energy Reform: A Game Changer in the Nation’s History,” *Mexico Institute, Woodrow Wilson Center*, 2014, and “Analysis of Proposed Hydrocarbon Legal Regime in Mexico,” *Mayer Brown LLP*, May 30, 2014.
[5] Decree that Amends Different Provisions of the Political Constitution of the United Mexican States in Energy Matters (official English translation) “Transitory Articles, Sixth, section (a), as published in the Mexican Official Federal Gazette Dec. 20, 2013, effective date Dec. 21, 2013.
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[7] Adrian Lajous, “Mexican Energy Reform,” p. 4, 10.
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