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Will Pemex remain “first among equals” under Mexico’s upcoming petroleum legislation?

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Mexico’s energy reform, which led to a major constitutional amendment in December 2013 and proposed implementing laws to be discussed this summer, has attracted great interest from global firms and investors. The reason is clear: Mexico was one of the very few countries in the world where a state energy monopoly prevailed in the hydrocarbon and electricity domains, and private participation was all but banned. The constitutional amendment modified some passages of Mexico’s famously protectionist Article 27 to open major aspects of the hydrocarbons and electricity industries to private interests through bidding, licenses, or contracts.

In the past few weeks, and according to the schedule announced when Congress passed the constitutional amendment, President Enrique Peña Nieto has submitted a series of proposed implementing laws to the legislature that will open Mexico’s energy sector. The hundreds of pages of text confirm a major liberalization of the energy industry—though in a policy scenario where Pemex, Mexico’s state oil and gas enterprise, seems to remain a major actor in the short to mid-term evolution of the nation’s energy sector.

According to the legislation pending congressional approval, Pemex will be transformed from a state monopoly to a public “productive” firm, meaning its main goal will be the same as that for any private energy company: to efficiently and

effectively optimize profits. In order to do so, Pemex will have the autonomy to prepare its annual business plan, and will emphasize the importance of industry expertise of its now 10-member board of directors by excluding representatives of the once powerful oil union and incorporating five independent board members from nongovernmental agencies. The other five members will be government officials, including the Secretary of Energy, who will act as board president. The board will have the ability to remove Pemex’s CEO and make major decisions concerning the allocation and disbursement of resources—a radical change from current practices in which most investment and expenditure decisions must be approved by the Treasury Department. Nevertheless, Congress and the Treasury will remain major actors in Mexico’s post-monopoly regime since both must approve Pemex’s annual business plan. Moreover, the Treasury Department will determine the financial terms of contracts between the state and private or public firms. Indeed, the intent of the legislative bundle is to create a divide between the contractual terms that apply to Pemex or any other public productive enterprise, and those that apply to private companies.

Under the proposed legislation, Pemex or any other public enterprise in Mexico is entitled to operate through leases; private operators will participate through contracts (either sharing utilities or production) or



licenses. While the legislation does not define leases, contracts, and licenses, the rights and entitlements derived from each mark the differences.

The Secretary of Energy has the sole power to grant leases, assessing technical and economic issues as well as strategic considerations that impact the government's energy security priorities. Under this system, Pemex will likely hold most of the fields with proven and probable reserves, which are onshore and offshore in shallow water. Joint ventures or public-private associations are not allowed under the leasing regime; private operators are only allowed to enter into service contracts. For Pemex or any other public firm to work with private firms, it will need to "migrate" from the leasing regime to a service contract or create a foreign affiliate. As previously stated, under the legislation sent to Congress, leases remain the exclusive domain of the state and its public companies; private participation is limited to the supply of services, as was the case during the monopoly regime. How can this "double standard" make sense when the purpose of the energy package announced by the government is to open all chains of the industry?

Though Article 27 of the Constitution opened all industry chains to private participation, Articles 25 and 28 kept upstream hydrocarbon activities—exploration and production—as strategic sectors, meaning they remain under the "exclusive" control of the state. What the amendment to Article 27 allows is private participation in upstream operations under certain conditions. Private interests may provide services under the leasing regime, or manage drilling activities for exploration and production under the contracts/licenses regime. In both regimes, rights and benefits can be suspended by state authorities if contractors—either public or private—fail to comply with the goals and requirements mandated under this two-tier system. In case of disputes, private firms can seek recourse through an international tribunal if their contracts or licenses do not give jurisdiction to Mexico's courts; Pemex

or any other public firm will be heard by Mexico's courts.

The proposed hydrocarbon bill underscores that upstream operations remain strategic for the state, as it allows the Secretary of Energy to support up to a 30 percent participation for Pemex or any other public firm when bidding contracts to private operators, if the tendered fields overlap with those of Pemex or if the Department of Energy decides that opportunities for technology transfers will upgrade the capabilities of public firms. In the case of cross-border fields, in which an agreement with the United States has already been signed and ratified by legislators in the U.S. and Mexico, a minimum 20 percent investment is mandated for Pemex. Last but not least, the proposed legislation provides that "safeguard zones" could be created (and liberalized) by presidential decree if Mexico's national interests and other energy security considerations are at stake.

The new legislation also purports to mandate a 25 percent "national content" target for any operator participating in upstream activities. Though the North American Free Trade Agreement (NAFTA)—in force for more than 20 years—explicitly forbids "performance requirements" favoring any national industry of a member country, Mexico explicitly exempted its energy sector. Chapter 6 of NAFTA sets the framework for a gradual liberalization of the energy industries of the three countries. However, during negotiations, Mexico made it clear that NAFTA rules would not affect the organization of the state's energy monopoly. Furthermore, Chapter 6 stipulates that when NAFTA and Mexico's constitution conflict, the latter prevails. Since the constitutional amendments introduced at the end of 2013 explicitly state that upstream hydrocarbon activities will remain under the "exclusive" domain of the state, it could be inferred that both energy exploration and production remain outside of NAFTA rules.

While the national content target under the new legislation will be managed differently from Mexico's pre-NAFTA industrial policies (in the automotive

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industry, for instance, foreign assemblers were required to reach specific annual targets), bringing back the idea of national content clearly demonstrates the strategic importance of the energy sector to the Mexican government—not only due to security concerns but also for economic and industrial reasons. National content requirements will give leverage to both the Department of Energy and the National Hydrocarbon Commission (CNH), which is in charge of administering and protecting the property rights of the nation, when crafting contracts between public and private firms. These two government bodies will be in charge of setting the national content target on an ad hoc basis when tendering leases or contracts and licenses. The Department of Economy will supervise and eventually enforce sanctions if the contracted targets are not reached.

The bundled energy bills pending in the legislature also differentiate the fiscal regimes for leases, contracts, and licenses. Under the current system, Pemex directly transfers its operating returns to the Treasury Department. The company must annually negotiate monetary transfers from the Treasury or increase its foreign debt in order to fund investments. Under the new fiscal regime sketched in the rather complicated Revenues Law submitted to Congress, Pemex will pay up to 71.5 percent of its operating revenues not to the Treasury, but to a new trustee—the Mexican Oil Fund for Balance and Development (Oil Fund)—which is administered by the Bank of Mexico. Although the proposed Revenues Law mandates other transfers, its intended goal is to reduce Pemex’s deficit of recent years. However, under the current proposal, production costs are capped for the purpose of estimating operating revenues. (Production costs are capped at US\$6.50 per barrel for drilling oil and associated gas, and US\$2.20 per thousand cubic feet for drilling non-associated gas.) At first glance, this fiscal regime—intended only for leases—encourages oil and gas production from mature conventional fields, but not from unconventional sources such as the heavy crude of the Chicontepec Formation,

the shale gas plays located in the Burgos Basin, or the deepwater resources where production costs exceed the caps set by the Revenues Law. In other words, the fiscal regime for leases suits well if Pemex or any other public firm is keen to develop onshore and shallow waters fields, which were already included in Round Zero. If Pemex is interested in developing unconventional resources, it should “migrate” its leases to contracts or form joint ventures with private companies under alternative fiscal regimes.

At any rate, the fiscal alternatives covering the three types of state-firm contractual relationships aim to maximize the taxation rate of oil rents generated by any kind of operator. According to the proposed implementing legislation, Mexico’s Oil Fund will be composed of many funds; the most important will be the so-called Compensation for Budgeted Income Fund, which handles the money that is transferred to the Treasury to balance government expenditures. Under the pending legislation, Mexico’s government estimates oil and gas revenues will be similar or higher than in the previous regime. The Compensation for Budgeted Income Fund should reach the equivalent of 4.7 percent of Mexico’s annual GDP. Though the Compensation Fund includes transfers to the subnational level and to scientific research-oriented bodies, Mexico’s Oil Fund also anticipates the creation of a Reserve Fund, equivalent to 3 percent of GDP, aimed at administering surplus resources for the needs of future generations. Although the Oil Fund will require Pemex and private companies to disclose their operating costs and investments, it is yet to be seen how transparent the operation of this three-tier fiscal regime will be. This will be crucial in determining the interest of private investors, and the extent to which it will affect Pemex’s—or any other public firm’s—investment decisions.

It is clear that Mexico will not simply rely on market mechanisms to attract investors from all nations to explore and develop the country’s huge untapped oil and gas resources. It is also clear that Mexico’s state agencies will not be

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mere regulators when the state's energy monopoly ends. The Department of Energy, the National Hydrocarbon Commission (CNH), the Department of Treasury, the Department of Economy, the Bank of Mexico, and the president himself will remain key actors in deciding the future development of upstream hydrocarbon activities, which will continue to be strategic domains under the control of the state according to the constitutional amendment. Pemex will remain the privileged state operator supporting exploration and production in most of Mexico's onshore and shallow water fields. Since major players such as the Department of Energy, the CNH, and the Treasury Department are entitled to enforce discretionary policies related to security, fiscal, and national content measures, they could bias the playing field toward Pemex or any other public enterprise against private investors—or the other way around, depending on the policy priorities and the political or ideological bents of the decision-makers.

The priorities and interests of private investors will test the new fiscal regime. In addition, it is unknown if the proposed implementing legislation will effectively turn Pemex into a truly competitive and efficient firm able to compete without policy bias against private investors. Will it be attractive enough to fuel investments for the development of Mexico's unconventional energy resources? Eventually, the most attractive areas for private investors, foreign or national, could be at the mid- and top-end of the value chain. Mexico urgently needs to develop oil and gas lines, as well as refineries, storage capabilities, and transparent and reliable retail outlets. Such downstream operations have ceased to be "strategic" domains for Mexico, and if expanded, they will likely be overseen by regulators and not subject to federal administrative law. Instead, Mexico's civil and merchant legal framework, as well as NAFTA regulations, will govern their operations.

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