

# ISSUE BRIEF **06.26.17**

## **The Winter of Our Discontent: The Implications of Mexico's Hefty Gasoline Price Hikes**

Miriam Grunstein, Ph.D., Nonresident Scholar, Mexico Center

### **INTRODUCTION**

Mexico's energy reform, which in 2013 opened the hydrocarbon sector to foreign investment, has had moments of pain and glory.<sup>1</sup> December 2016 is a case in point. The month started well, with Mexico successfully auctioning oil-rich acreage to several large and reputable foreign oil companies, which are now licensed to explore and extract energy resources in the ultra-deep waters of the Gulf of Mexico.<sup>2</sup> Weeks later, however, during the Christmas season, Mexicans were hit with a sharp increase in gasoline prices.<sup>3</sup> At the same time, the peso depreciated faster than the dollar, and the price of oil rose. Thus, as people were traveling during the holidays, driving their cars, and spending their Christmas bonuses, Mexico's economy became a financial roller coaster, making some angry<sup>4</sup> and others fearful. Many just shook their heads, recalling the government's promise that reforms would guarantee lower prices for gas and electricity. Deceit? Chaos? Urgency? Lack of transparency in fundamental policy decisions? Perhaps all of the above.

### **REALITY OVERTAKES EXPECTATIONS**

The events of December 2016 did not come out of the blue. The administration of President Enrique Peña foresaw trouble back in February 2015 as certain reform-related events unfolded more quickly than anticipated.<sup>5</sup> For example, the original date for the liberalization of fuel imports,

January 2017, was moved to April 2016 as Pemex strained to satisfy even 40 percent of domestic consumption. Three arguments were offered to justify the accelerated timetable for liberalization: it would attract investments for transport and storage facilities, promote competition, and thereby lower consumer prices. However, such developments were unlikely in a post-reform environment where many complex challenges remained. If market dynamics and competition, and not state control, are to be the main drivers of lower oil prices in Mexico, the barriers discussed below must be overcome.

According to a study by the Centro de Investigación y Desarrollo A.C. (CIDAC),<sup>6</sup> the first challenge to market competition in Mexico's energy sector stems from the ownership of facilities for fuel transportation and storage. Before the reform, Pemex alone had the legal power to refine, import, store, and sell fuel, making it legally impossible and economically foolish for others to compete. This historic limitation of midstream and downstream facilities has put newcomers at a disadvantage: it is a risk for them to intensively invest in new infrastructure while there are still many uncertainties about using Pemex's facilities in the interim. For example, as will be explained below, it is difficult for foreign oil companies to determine the tariffs for transport and storage facilities that would be payable to Pemex.

Another obstacle noted by CIDAC, as well as many other analysts, is the long history of state price controls on fuels. For



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as long as many can remember, people have purchased gasoline for less than its true value. Inexpensive gasoline was perceived as a right because Pemex was perceived as a public service. For years, subsidized gasoline was also used to keep people happy with the government. The problem, however, is the socio-economic bracket that was kept the happiest: several analysts and think tanks have pointed out that fuel subsidies have primarily aided those prosperous enough to own SUVs and other large, gas guzzling vehicles.<sup>7</sup>

The CIDAC report also noted challenges concerning a closed circle of retail gasoline suppliers that is organized in business groups operating in specific regions of Mexico.<sup>8</sup> According to CIDAC, these groups do not create competition through service station ownership and operation. In fact, they may actually create entry barriers for foreign oil companies—particularly if they have implicit alliances with the state or municipal governments that award important permits for land and water use as well as waste disposal. Another challenge of the service station oligopolies, CIDAC notes, is they are often concentrated in regions where gas stations are spaced far apart and drivers have to travel 20 kilometers or more to get gasoline.<sup>9</sup>

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### THE INEVITABLE GAS PRICE HIKE

These circumstances have existed for decades and are not attributable to any particular presidential administration. The bottom line: there is not enough subsidized fuel to satisfy Mexico's needs. Thus, free market forces had to be allowed to operate—which implied raising the price of gasoline to its actual value. Over the course of Felipe Calderón's presidency (2006–2012), gas prices gradually crept up, increasing an average of 60 percent during his tenure.<sup>10</sup> It was during this time that the term “gasolinazo”—slang for fuel price hike—was coined. The word's negative connotations included the idea that the increases were arbitrary, lacked transparency, and were examples of government abuse. A major issue was that officials did not explain

the real reasons behind the price hikes—thereby angering consumers who did not understand why they were paying more at the gas pump. In the Peña administration the situation worsened because, to encourage support for the energy reform, the government made unfounded promises of gas, electricity, and fuel price reductions. For example, in 2014, then-secretary of the treasury Luis Videgaray said that Mexicans could bid farewell to “gasolinazos” as one of the gifts of the energy reform.<sup>11</sup> This only deepened the public's indignation when gas prices continued to rise.

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### CONDITIONS WORSEN

In December 2016, not long after Mexico successfully completed its bidding round for oil acreage in the Gulf of Mexico, Mexicans faced the startling truth about the country's weakening energy security. Contrary to Videgaray's promise about lower prices, gasoline was becoming scarce and its price was on the verge of an even more dramatic increase. Shortly before and during Christmas, there were long lines at gas stations in 13 Mexican states. Through its Twitter feed, Pemex said this shortage was mainly due to harsh weather conditions in the Port of Tuxpan and fuel theft along the Salamanca–Irapuato pipeline. There was some truth to that. In 2016, Pemex suffered losses of 90,000 liters per day in the Minatitlán–Mexico pipeline alone due to organized crime. Pemex also explained the shortage was a result of maintenance work in the Cadereyta refinery and increased consumption during the holiday season.

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### A CHRISTMAS GIFT: LIBERALIZATION

With another gasoline price hike imminent, the Energy Secretariat and the Federal Energy Regulatory Commission (CRE) on December 21, 2016, announced a series of measures that would, in its words, “empower consumers” by accelerating the introduction of competition, introducing price flexibility in some areas, and gradually liberalizing prices in other regions. So far, Baja California and Sonora are the

only states that have floating gas prices. The government also implemented an intervention program: the Department of the Treasury was to determine gasoline prices, which meant that the agency would continue to manage prices, except in liberalized areas, where it nevertheless incorporated a considerable tax into the price of gas. Further, the government announced a 20 percent price increase that was to start January 1, 2017; a confusing schedule of increases in the weeks that followed was soon abandoned.<sup>12</sup> However, the government put a cap on price “flexibility” that no retailer could exceed. Also, a special tax for goods and services, which had been variable, would be fixed in order to increase revenue by 209 billion pesos in 2017.

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### JUSTIFYING THE NEW STATUS QUO

In order to justify the January price hike, the Treasury Department said that the devaluation of the peso and the increase in oil prices had left the government with no other option. This argument was unpopular, as it seemed fundamentally unfair to raise gas prices due to market conditions, when consumers never benefited when the price of oil was lower. Also, taxes make up a large part of the cost of gasoline in Mexico, which strongly suggested to many that the government was primarily motivated by a need to collect more tax revenues in the face of dropping oil revenues. So, in effect, each gas station in Mexico has become a tax collector. Consumers know that.

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### CONDITIONS WORSEN FURTHER

For Mexicans, January 2017 brought more bad news. Those who had Christmas bonuses had spent them on gifts and perhaps a short trip, but Mexicans who traveled to the United States paid higher prices for their vacations and came back home to steep inflation, credit cards bills, and annual property and car registration taxes. New Year’s celebrations in Mexico felt like a pressure cooker; some even rioted, smashing windows of department

stores. The winners were those who had opposed energy reform. They blamed the government for the “gasolinazo.” Many argued that the Peña government had finally destroyed Pemex to the point that it could no longer provide for the people of Mexico.

Citizens continued to be angry about rising gas prices throughout January. The mainstream media and Mexicans on social media blamed the government. Even NGOs that had previously criticized gas subsidies said that the higher prices were unjustified. Some accused the government of theft and corruption. Others lamented the decline of Pemex and its conversion to a net importer of gasoline, which, they said, endangered Mexico’s energy security—particularly in light of President Donald Trump’s hostile statements about Mexico.<sup>13</sup> Thus, concerns about Mexico’s inability to provide for its own were compounded by worries that U.S. exporters would turn their backs on their neighbor. A higher level of discussion focused on the economic sense of the price hike. While it was understandable that gasoline could not be as cheap in Mexico as in Texas due to the great inefficiencies of Mexico’s midstream and downstream facilities, the rise in oil prices, and the devaluation of the Mexican peso, it was recognized that public spending was being propped up by gasoline tax revenues rather than financed through oil revenues or higher taxes for the wealthy. Also, there were issues concerning the rationality and transparency of public spending. Was the government using every peso paid to service stations reasonably and in a transparent manner? Most doubted that.

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### BACKPEDALING AGAIN

In February 2017, the government backed off from yet another price increase that had been planned for the 17th. On February 22, however, gas prices unexpectedly fell by a few cents, depending on the brand of gasoline.<sup>14</sup> Further, in the hopes that liberalization would be an incentive to lower gas prices, the CRE announced that on March 30, the states of Baja California and Sonora would be completely free from

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state controls. In these northern states, the market is now the price setter instead of the Department of the Treasury.

However, liberalization has not reduced gas prices in those states. To the contrary, service stations have *raised* prices, partly because the cost of imports is higher due to inadequate port, distribution, and storage infrastructure along the Pacific Ocean. Companies who entered the market after reforms have also stated that regulatory costs (permitting, licensing, and authorizations) at the federal, state, and municipal level impeded the sale of cheaper gas. In addition, contracts with Pemex reduced the companies' profit margins from 7.5 percent to 6.7 percent. If independent service stations were to survive the early stages of market reforms, they could not afford to lower prices.

Of course, price trends are not a secret. The CRE created an application called GASOAPP,<sup>15</sup> which functions like the GPS navigation app Waze and tracks prices at Mexico's gas stations. At a glance, one can see that there are vast "red" paths of scarce and expensive gasoline in Mexico. There are several reasons for this that go beyond the devalued peso and the high price of oil. First, Pemex's refining facilities are underutilized and in critical condition, as are its pipelines and storage terminals. However, not one publicly available study investigates the extent of the damage or offers options to repair, reconfigure, and convert refining and ancillary facilities. Second, fuel theft has gravely affected the market, with thieves targeting both pipelines and oil tank trucks, and the black market has only grown.<sup>16</sup> Each cent criminals manage to gain is a loss to companies and consumers.

### MUDDLING THROUGH

Despite these gaps in analysis and knowledge, the government has rushed to implement its post-reform plans, albeit with poor results. In early March 2017, a snafu occurred at the public auction of the pipelines and storage terminals owned by Pemex Logistics. This auction was suspended due a "methodological failure," which resulted

in a minimum tariff that was far below the commercial rate payable to Pemex for the use of its facilities. The results of the auction were vital for the participating companies, which included major foreign oil companies, independent refiners, traders, and retailers. Because of the error, these companies have had to put their business plans on hold until the regulatory authorities are able to announce the winners. While the results were to be announced by the end of March, the outcome of the auction is still unknown.

### CONCLUSION

Today, the price of gasoline in Mexico has gone down a few cents and has remained stable since December 2016. People have gone on with their lives, complaining but still buying gasoline. In fact, the country's first BP station opened in Ciudad Satélite, a suburb in the northern part of the metropolitan area of Mexico City, and the line to fill the tank at this station is usually long. It starts at the exit ramp of the main freeway and ends at the pump. One wonders why this is so, since BP charges the same price for the same gasoline supplied by Pemex. However, some say that the additives BP blends into the gasoline make it a better fuel; others may go out of sheer curiosity.

What are the implications of the "gasolinazo"? It did not cause inflation, and the cost of land transportation systems has risen only moderately. The government has not, however, pushed to increase gasoline choices in urban areas—where it would make economic sense given the larger population—and it has not designed a fairer pricing system for poorer segments of the population. Thus, the "gasolinazo" may yet affect energy reforms, especially because the reform was based on a promise that has so far proven false: that fuel prices would drop. As noted throughout this brief, the opposite has occurred. It is unfortunate because Mexicans have a hard time accepting that free markets can be beneficial since previous privatizations—in telecommunications and banking, for example—while not unsuccessful, have fallen well short of consumer expectations.

## ENDNOTES

1. On December 20, 2013, articles 25, 27, and 28 of the Mexican Constitution were amended so that private and state companies, both domestic and foreign, could participate throughout the hydrocarbons value chain. In August of the same year, the secondary legislation was enacted, with nine new laws and 12 amended ones. This change eliminated the exclusivity of Pemex and the Federal Electricity Commission (CFE) in Mexico's energy sector.

2. For further details of the participants and winners of this auction, see <http://www.gob.mx/cnh/articulos/rondas-mexico?idiom=es>.

3. The press release concerning price increases and flexibility can be found at <https://www.gob.mx/shcp/prensa/comunicado-de-prensa-112-2016>.

4. Riots resulted in deaths and arrests, especially in the state of Veracruz. See, for example, Raúl Cortés, "Las protestas por el 'gasolinazo' en México dejan ya tres muertos y más de 600 detenidos," *El Mundo*, January 6, 2017, <http://www.elmundo.es/internacional/2017/01/06/586f6f1fca474181198b459f.html>.

5. The original and final calendar for gasoline imports, liberalization, and flexibility can be viewed at <http://www.gob.mx/cre/articulos/estrategia-de-flexibilizacion-de-los-mercados-de-gasolinas-y-diesel?idiom=es>.

6. See <http://cidac.org/gasolina-en-mexico-retos-en-competencia-hacia-libre-mercado>.

7. In addition to CIDAC, the Instituto Mexicano para la Competitividad (IMCO) has been highly critical of gasoline subsidies. To read about the myths of gasoline subsidies, see "Mitos sobre el subsidio a la gasolina," [http://imco.org.mx/articulo\\_es/mitos-sobre-el-subsidio-la-gasolina/](http://imco.org.mx/articulo_es/mitos-sobre-el-subsidio-la-gasolina/).

8. CIDAC, <http://cidac.org/gasolina-en-mexico-retos-en-competencia-hacia-libre-mercado>.

9. Ibid.

10. *Proceso* magazine published an infographic showing the increases in fuel prices in Mexico. See "Los gasolinazos en los sexenios de Calderón y Peña," *Proceso*,

December 27, 2016, <http://www.proceso.com.mx/467875/los-gasolinazos-en-los-sexenios-calderon-pena-graficas>.

11. The media fully reported this announcement. See, for example, Néstor Jiménez, "No habrá más gasolinazos a partir del 2015, SHCP," *La Razon*, September 5, 2014, <http://razon.com.mx/spip.php?article228273>.

12. The official press release can be viewed at <http://www.gob.mx/profeco/prensa/comunicado-de-prensa-conjunto-presentan-estrategia-de-flexibilizacion-de-mercados-de-gasolinas-y-diesel>.

13. See "Donald Trump's presidency is about to hit Mexico" January, 15, 2017, <http://www.economist.com/news/americas/21714397-protectionist-entering-white-house-mexico-ponders-its-options-donald-trumps>.

14. See "Baja 2 centavos la gasolina Magna y el Diésel y 1, la Premium" *Excelsior*, April 19, 2017, <http://www.excelsior.com.mx/nacional/2017/04/19/1158484>.

15. An explanation of the GASOAPP and its terms and conditions can be found at <https://www.gob.mx/cre/documentos/terminos-y-condiciones-gasoapp>.

16. This is not a new problem, but *The New York Times* recently published a front page story on the topic and its important consequences. See Kirk Semple, "In Mexico, an Epidemic of Fuel Thefts Becomes a Crisis," *The New York Times*, April 26, 2017, [https://www.nytimes.com/2017/04/26/world/americas/mexico-fuel-theft-crisis.html?emc=eta1&\\_r=0](https://www.nytimes.com/2017/04/26/world/americas/mexico-fuel-theft-crisis.html?emc=eta1&_r=0).

## AUTHOR

**Miriam Grunstein, Ph.D.**, is a nonresident scholar at the [Baker Institute Mexico Center](#), chief energy counsel at Brilliant Energy Consulting, and a professor and researcher at the Universidad Autónoma de Nuevo León. Her consulting and research focus on energy law, public regulation, administrative law, and international transactions.

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