

# ISSUE BRIEF **02.27.20**

## Lights Out in Mexico's Upstream Market?

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### INTRODUCTION

Before Mexico's historic energy reforms in December 2013, Pemex, the state-owned petroleum company, had the exclusive right to explore and extract all of Mexico's hydrocarbons. Only service companies hired by Pemex were allowed limited participation in this part of the oil and gas value chain. However, a very significant change to the wording of Article 27 of Mexico's Constitution opened the country's energy sector to outside interests. Between 2015 and late 2018, the National Hydrocarbons Commission (CNH) organized and launched three rounds of tenders—or bidding rounds—in which 112 contracts were awarded to oil companies national and foreign, private and state owned, including Pemex.<sup>1</sup> For the first time since 1938, oil companies from all over the world participated in the exploration and production of Mexico's most coveted natural resource. However, the euphoria that followed the liberalization of Mexico's energy sector would not last.

This paper tracks a change in direction for Mexico's energy policy under the administration of President Andrés Manuel López Obrador (AMLO)—a change that inhibits private investment in hydrocarbon exploration and production while attempting to restore Pemex's oil monopoly, likely to the detriment of Mexico's energy security.

### AMLO'S AMBIVALENCE TOWARD THE OPENING OF EXPLORATION AND PRODUCTION

Throughout his 18-year rise to the presidency, López Obrador had criticized, even condemned, the opening of Mexico's oil industry to private and foreign investors.<sup>2</sup> In his view, Pemex should be the sole extractor and provider of Mexico's domestic hydrocarbon reserves.

AMLO toned down this message as his presidential campaign evolved and the 2018 elections drew near. Publicly, he became vague about the desirability of letting companies other than Pemex be oil operators. However, he did stress that the contracts awarded during his predecessor's administration would be "reviewed,"<sup>3</sup> although it was never clear what he meant by this. Did he mean he and/or his subordinates would simply read the contracts awarded by the National Hydrocarbons Commission (CNH)? This could be done by anyone, since the contracts are part of the public record. Did AMLO mean he would review the terms of the contracts in force in order to adjust *future* contracts? This also was acceptable, for the law provides that if one or more of the contract provisions substantially inhibits participation of oil and gas companies other than Pemex, the relevant text could, in general, be reviewed, removed, or replaced in *subsequent* contracts.

The most alarming interpretation of the president's statement about reviewing contracts in force was that the government



**A change in the direction of Mexico's energy policy under AMLO inhibits private investment while attempting to restore Pemex's oil monopoly.**

would make modifications in the national interest. However, modifying contracts that have been signed and are in force is illegal. Mexico's Hydrocarbons Law<sup>4</sup> and the contracts themselves forbid any alteration of the terms and conditions under which the agreements were signed.<sup>5</sup> This prohibition exists to protect contract holders against arbitrary decisions by the government. Only by violating the Hydrocarbons Law and breaching contracts could the government alter the terms in force in any way.

### Administrative Rescission

What the government can do, under the Hydrocarbons Law and according to the terms of the contract,<sup>6</sup> is enforce "administrative rescission." This provision entitles the government to rescind (terminate) the contract for "just cause." Under the law, "just cause" can refer to an accident that causes injury, death or severe environmental damage; reporting false information to financial and/or other authorities; and unjustified delays. The CNH initiates the administrative rescission process by notifying the company that it is subject to one or more of the "just causes" for rescission. When possible, the company may then try to remedy the situation. If the breach is corrected to the satisfaction of CNH, the rescission process may be stopped. If not, the company will have 15 days to present its case before the CNH and will be notified of CNH's decision within another 15-day period. It should be noted that this decision cannot be challenged by way of international arbitration. The company may only seek recourse in Mexico's courts, which has the disadvantage of a judiciary that is inexperienced in oil and gas matters and is unlikely to rule against what could be interpreted as the "national interest."

From the beginning, administrative rescission was one of the major risks companies considered when participating in the tender process for Mexican exploration and production contracts. Due to its immense consequences, administrative rescission was deemed a potentially "deal-breaking" provision, despite the fact that

Mexico's reserves hold great promise.<sup>7</sup> The risk of a possibly arbitrary action by the government was perceived as the ultimate threat to the companies' interests. The great geological and financial risks of deepwater projects, for instance, would have been unacceptable had the contractual causes for rescission remained relatively general. It could be fatal for a work delay to be called a cause for rescission, as no deepwater project can be subject to a strict schedule. Due to geological uncertainties, these projects require a reasonable degree of operational flexibility to be successful. In light of such issues, the government added to the contracts a statute of limitations for administrative rescission,<sup>8</sup> and the causes for rescission established in the contracts were narrowed to lessen the possibility of arbitrary action.

CNH awarded nearly 30 contracts during Rounds 1 and 2 of Mexico's oil auction.<sup>9</sup> This was because the contracts were flexible enough to avoid the possibility of rescission without just cause; AMLO would not be able to alter the terms.

However, the threat of administrative rescission again emerged when AMLO, shortly after his inauguration, announced that all companies that had been awarded contracts would be given three years to produce oil. Regardless of the technical and geological complexity of some of the areas under contract, such as drilling in ultra-deep areas or in challenging subsurfaces, he accused the companies of failing to produce oil for Mexico, thus harming the public interest.<sup>10</sup> AMLO's statement was alarming not only for the existing contractors but also for the companies who expected Mexico to be a promising location for future exploration and production ventures.

López Obrador also announced that his government would not schedule future bidding rounds until the companies engaged by his predecessor's administration proved they could meet the terms of their contracts. In addition, the president said that tenders for shale plays would be suspended until further notice and that his government would not pursue any further deepwater hydrocarbon exploration and production.<sup>11</sup>

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## THE END OF MEXICO'S ENERGY REFORMS?

With contracts in question and tenders suspended, another piece of bad news for global investors came: the early resignation of Juan Carlos Zepeda, CNH's chairman, who had won international recognition for his successful implementation of Mexico's energy reform. Zepeda's term expired at the end of the first quarter of 2019, but he resigned when the new government took office in December 2018. The reasons for his early departure were not clear. The press reported that Rocío Nahle, who had not yet assumed his duties as secretary of energy, had asked Zepeda for his resignation. Zepeda denied this, saying that he had resigned due to personal reasons and would remain close to the new government as an external advisor to the energy secretary.<sup>12</sup>

These events sent signals that Mexico was no longer the accommodating host it had been for the previous five years. Furthermore, a change of the guard at Pemex—the appointment of a new CEO—was also disconcerting. Previous CEOs had been technocrats who were at least friendly to, if not outright advocates for, the open model established by Mexico's energy reform. López Obrador's appointment of Octavio Romero, a close political supporter, raised concerns. Romero was an agrarian engineer who had been part of AMLO's team in the state of Tabasco and a member of his mayoral staff in Mexico City.<sup>13</sup> With no experience in the energy industry and no background in business, Romero has been a soft-spoken and almost invisible CEO. Never before in the history of Pemex has Mexico's president exerted such direct and visible authority over the national oil company. By appointing Romero, AMLO is pursuing full control of decisions in oil and gas matters. One of his top priorities is to have Pemex return to the limelight as a producer.

## WHY MEXICO CANNOT DO WITHOUT PRIVATE INVESTMENT

Hydrocarbon production in Mexico has hit historically low numbers since AMLO took office in 2018. In 2004, Pemex's output peaked at 3.5 million barrels per day.<sup>14</sup> Pemex is currently producing 1.6 million barrels per day and, for the first time ever, has begun to import light crude oil for the domestic refineries that cannot process the heavier Mexican crude.<sup>15</sup> To stimulate production, López Obrador approved for Pemex tax reductions of 15 billion pesos, or around US\$750 million.<sup>16</sup> This measure was announced along with a government investment in Pemex equal to US\$5.5 billion.<sup>17</sup> Investors in New York responded negatively to these announcements, and in 2019, rating agencies downgraded Pemex's credit rating.<sup>18</sup>

To increase production, Pemex will issue new calls for tenders for service contracts, probably in 2020. And while the tax reductions and capital injections are positive, these steps are far from sufficient to put Pemex on firm footing. In order to operate properly, Pemex must continue building alliances with other oil and gas companies in order to share geological and financial risk.

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## CONCLUSION

The implications of Mexico's decline in hydrocarbon production go beyond Pemex and have affected Mexico's sovereign bonds.<sup>19</sup> As the country's financial credibility is sustained primarily through hydrocarbon reserves and production, policy errors concerning exploration and production reverberate in the rest of the economy.<sup>20</sup> The fates of Mexico and Pemex are closely intertwined.

López Obrador has tried to persuade the international financial and business community that a clear financial strategy is not all that matters insofar as Pemex is concerned. Production may be declining but, according to AMLO, honesty is on the rise. The president has argued that the

credit rating agencies are hypocritical for not having condemned Pemex in previous administrations when corruption was at its highest point.<sup>21</sup> The president believes his efforts have been unappreciated and misunderstood,<sup>22</sup> and he has blamed rating agencies for the diminishing credibility of Pemex and Mexico.<sup>23</sup>

In the past, oil production has given Mexico's government substantial cash flow to pursue its goals. This will not be the case for the López Obrador presidency. This time, the president will have to face the limitations posed by declining hydrocarbon production.

## ENDNOTES

1. Detailed information regarding bidding rounds, tenders, and contracts may be found at <https://rondasmexico.gob.mx/esp/contratos/>.
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5. As established in Chapter 15, Section II of the Hydrocarbons Law.
6. The contracts are available at <https://rondasmexico.gob.mx/esp/contratos>.
7. For a full report (in Spanish) on Mexico's hydrocarbon reserves, see <https://reservas.hidrocarburos.gob.mx/>.
8. For precision regarding the causes of administration rescission, see (in Spanish) <https://rondasmexico.gob.mx/esp/contratos>.
9. See (in Spanish) <http://www.amexhi.org/comunicados/resultados-de-la-licitacion-de-la-ronda-2-4/>.
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14. See "Estadísticas Petroleras de febrero de 2019," available at <http://www.pemex.com/ri/Publicaciones/Paginas/IndicadoresPetroleros.aspx>.
15. See "Pemex asigna cuatro cargamentos para importar crudo ligero," at [http://www.pemex.com/saladeprensa/boletines\\_nacionales/Paginas/2018-086-nacional.aspxn](http://www.pemex.com/saladeprensa/boletines_nacionales/Paginas/2018-086-nacional.aspxn).
16. "Apostar por el 'rescate' a Pemex, ¿vale la pena?" *Expansión*, April 9, 2019.
17. "El plan de AMLO para rescatar Pemex no convence a los mercados," *El Economista*, February 16, 2019, <https://www.economista.com.mx/economia/El-plan-de-AMLO-para-rescatar-Pemex-no-convence-a-los-mercados-20190216-0006.html>.

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22. Ibid.

23. Rolando Ramos and Yolanda Morales, “Chocan AMLO y Fitch por baja en la nota de Pemex,” *El Economista*, January 31, 2019, <https://www.eleconomista.com.mx/economia/Chocan-AMLO-y-Fitch-por-baja-en-la-nota-de-Pemex-20190131-0010.html>

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