Market Note 168
Houston, May 21, 2013

Benchmarking Expectations for Mexican Energy Reform (Part IV):

Corporate Governance and Public Oversight

ON MAY 18, 2013, "Mexico Grows at Slowest Pace in Three Years" was the title of a story in the *Wall Street Journal*. The Pact for Mexico "has already led to passage of sweeping education and telecommunications overhauls, increasing hopes that an oil-sector reform planned for the second half of the year will be equally ambitious." Few doubt that an oil-sector reform is coming, but many doubt that it will introduce market drivers.

In earlier reports (Market Notes 154, 165, 166 and 167) we have sought to set forth—in Houston English—what a market-oriented reform might look like; that is, a reform that would lead to increased production and investment based on competition and the expectation of market rewards in an orderly, well regulated operating environment.

In this report we shall benchmark market metrics related to corporate governance and public oversight in the oil sector.

As a point of reference, in numerous places we draw on an extensive report on Pemex corporate governance that was prepared by the OECD Secretariat in 2010.

This series of reports provides benchmarks with which to evaluate the proposals for energy reform that the government will make public in the fall of 2013.

While it is not expected that the proposals will be of the kind that could be described as market-driven; nevertheless, to add precision to the discussion, it will be useful to identify those institutional arrangements, as well as constitutional, legal and regulatory precepts, that would need attention by authorities and legislators were there intent to shift the Mexican energy sector from a state-driven to a market-driven model.

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CORPORATE AND BOARD ARRANGEMENTS AT PETROLEOS MEXICANOS:

EVALUATION AND RECOMMENDATIONS

Report by the OECD Secretariat, prepared on the request of Petróleos Mexicanos (PEMEX) and the Mexican Authorities

1September 2010

ASSESSMENT AND RECOMMENDATIONS

PEMEX is of vital importance to the Mexican economy and to Mexico's ability to realise its social and developmental objectives. In addition to employing some 140,000 people and contributing around a third of the federal fiscal revenues, it is also a major contractor of private sector goods and services and is an important source of foreign exchange.

It is therefore essential for Mexico's future that PEMEX be a world- class company. This report suggests how this goal can be achieved and the benefits realised without embarking on a process of privatisation or other steps deemed inconsistent with the Mexican constitution.[1]

World-class company without privatisation or liberalisation

Until November 2008, PEMEX was not a company but a parastatal entity perceived to face major problems that are often associated with state commercial activities. The entity was highly inefficient, with a poor operating culture and has been the focus of allegations regarding corruption and poor procurement practices. Yet, nobody appeared to be fully responsible and accountable for its poor performance.

The Mexican authorities and the Congress reacted to these deficiencies by passing a new legal framework in November 2008 that represents an important step toward corporatizing PEMEX and its subsidiaries. The objectives of the company have been clarified, it has been granted greater financial autonomy and the responsibility for upstream regulation was shifted to a new body, the National Hydrocarbons Commission. Importantly, there was from the start of the process a clear recognition that the new company could only resolve past problems by adopting good corporate governance practices. Thus, increased operational autonomy, including the ability to adopt its own internal regulations, has been matched by greater authority of the PEMEX Board to monitor management. New members of the Board have been appointed and Board committees established.

Pemex's initial experience with the corporate governance arrangements has not lived up to expectations.

Good corporate governance is not, however, something that can be easily legislated. It is hardly surprising that, despite substantial progress, the initial experience with the corporate governance arrangements has not lived up to expectations:

- Conflicting objectives across major constituencies with a stake in PEMEX decisions are not resolved at the correct level, which is to say, by the state acting as an owner outside the company and the Board.
- Because the Board remains an arena for setting company objectives, each

[1] Such a constraint on the recommendations of the reports suggests that the original mandate precluded privatization or any measures that would entail competition—Ed.

constituency places representatives on the Board to uphold its interests, and the Board does not get on with its real job of agreeing on strategies to achieve objectives and overseeing management.

- The Board has inadequate support, especially in the form of an internal auditor and a corporate secretary that are accountable to it alone. This fosters distrust between the Board and company executives, as well as continual informal checking on management by Board members trying to control their actions.
- The full-time personal commitment required of some Board members as well as the personal staff attached to them blurs the distinction, authority and responsibility of the Board and executive management. [end p. 4]
- The proliferation of Board activities away from core functions results in a high number and long duration of Board meetings and of Board committees. It also encourages the use of alternates by Board members which reduces the Board's effectiveness and authority.
- The Board processes have had the unintended effect of weakening professional management, especially that of the CEO.[2]

Should this situation persist, it will be impossible to change the culture of the company and improve performance. What remains now is for all parties to see where arrangements can be adapted to improve the situation.

This report identifies a number of issues that need to be addressed in order to achieve the good governance that will be the foundation for PEMEX's successful long-term future. The recommendations are divided into two main categories:

1) First, there are measures which in the opinion of the Secretariat should be implemented quickly through either administrative decisions of PEMEX or the Mexican federal authorities.
2) Second, there are "structural changes" that may or may not necessitate legal change, but which will most likely take more time and call for a renewed commitment at the political level to further reform. However, although individual recommendations are made, changes to behaviour and practices are inter-related so that they need to be taken as a whole and not implemented on a partial basis: one without another might make the situation worse.

Measures for quick implementation

The Federal Executive should take the initiative:

- The Federal Executive should consider communicating its expectations of commercial and non-commercial objectives for the company through a letter to the Board, also setting out medium-term guideposts. This may allow the Board to better resist ad-hoc political pressures. Developing such a letter of intent would probably imply a degree of co-ordination and reconciliation of different ministries' points of view.
- The Federal Executive should consider establishing a committee within the Federal Executive consisting of representatives of the relevant ministries. This committee would make proposals to the Executive regarding the appointment of

[2] Actually, Pemex does not have a CEO as the term is generally understood in global corporations. The "Director General" of **Petróleos Mexicanos y Sus Organismos Subsidiarios** is only one of five directors general appointed by the Office of the President—Ed.

members of the Board. It could also play a coordinating role among the ministries currently represented on PEMEX's Board. It could also act as an "owner" by appointing the external auditor and approving the company's financial accounts. It is, however, important to ensure that such a coordinating committee does not become a "shadow board" for the company. (Such a committee could also exercise the same ownership function vis-à-vis other Mexican state-owned companies.)

A coordinating committee to identify prospective, qualified board members

- Of the six ministerial members of the Board, only the Minister of Energy and the Minister of Finance are, according to the laws actually in force, appointed ex-officio. That leaves four posts that could be filled in any way the Federal Executive decides (preferably pursuant to the advice of the committee proposed above).The Executive should consider appointing Board members with proven experience and expertise from the hydrocarbons sector, business and finance. If the current requirement that they should be "public officials" is seen as precluding Board members from the private sector, a solution could be to appoint non-political civil servants (or, perhaps, retired executives from the private sector on whom public official status could be bestowed) with more [end p. 5] direct expertise on matters pertaining to the business of PEMEX and more time to personally devote to their Board work than officials from ministries.

- The nomination of the four "professional" members of the Board should be made transparent and merit-based. A politicised appointment process does not allow the best persons to get the job. If a coordinating committee were established, it could be charged with identifying a pool of particularly well qualified candidates, from which the Federal Executive and the Senate could choose.

PEMEX and its Board can also improve the existing situation:

- The use of alternate Board members should be restricted to extreme circumstances.[3]
- Board meetings should only involve people wielding power on behalf of the company.

  The CEO should be invited to attend all Board meetings and relevant committee meetings except when his remuneration and employment conditions are discussed.

- The Chair should impose strict disciplines to avoid excessively long Board meetings and focus on concrete Board decisions. These disciplines should also apply to Board committee meetings and to the Boards of subsidiaries.

- The work of the Board committees needs to be streamlined to enhance efficiency. Committees should enhance Board decision making and not function as "mini-boards" making decisions prior to Board meetings. Since the subject matter of some of the seven required committees overlaps, joint meetings should be considered.

- The Boards of subsidiaries should be clear that strategy is set at the level of the main Board and implementation is overseen by it.
- The Board should embark on an annual process of self-evaluation perhaps with an external facilitator. Appropriate training should be provided.

[3] Historically, it is common for the cabinet ministers who are named to the board to send their representatives—if, for no other reason, they receive no additional compensation for their attendance—Ed.

- An internal auditor accountable to the Board should be established and ways found to reduce the extensive level of internal regulation. A corporate secretary accountable to the Board should also be established.
- A confidentiality policy needs to be established and unauthorised disclosures regarded as a breach of Board duties.

Such measures, if taken together, would serve to improve the professionalism of the Board and establish a sense of collegiality. This would allow management to function in a more effective manner while at the same time improving its sense of accountability to the Board.

Structural Changes

Nevertheless, although the 2008 PEMEX law marked a major reform effort, further changes to the legal and operating environment of PEMEX need to be considered:

PEMEX should become a normal limited liability company

- PEMEX should become a normal limited liability company, or at least a statutory corporation following as closely as possible company law.[4]
- The responsibilities of the members of the Board and the management executives need to be more clearly defined. The current law defining joint responsibility is inadequate. The Board should be accountable to the state in appointing the CEO [end p. 6]

A new oversight agency would obviate the need for cabinet ministers on the Pemex board

- The role of the state as an owner of PEMEX needs to be centralised in a body that also sets company objectives, both commercial and non-commercial.
- With ownership and monitoring centralised in one agency subject to Congressional oversight, it would be no longer necessary to include Ministers, and political civil servants on the Board. The Board nomination process should be structured and under the auspices of the agency.

The system of four full-time Board members should be terminated

- The system of four full time Board members should be terminated as it leads to "shadow executives".
- Union members of the Board should be designated in a way that ensures their necessary competence and skills as well as their personal responsibility as board members.
- Excessive regulation, such as that determining the corporate governance arrangements, needs to be streamlined. The four subsidiaries of PEMEX should be run by their own boards comprising only management executives, but under the oversight of the main Board through internal controls, risk management and compliance mechanisms. Company strategy should be set by the main Board.[5]

Such immediate and longer term reforms would go a long way to overcome the present PEMEX reality of a dysfunctional company: a board that is micro-managing the company with conflicting objectives and a management that lacks clear direction and powers to act, subject to reasonable checks and balances.

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[4] The report does not identify the benefits to be obtained by converting Pemex from a government agency to a normal limited liability company—Ed.

[5] The idea that the Board sets Pemex's strategy is belied by the constraints of law, regulation and tradition. Further, the Board lacks authority to set its own agenda. Suppose, for example, that the Board wanted Pemex to carry out a global talent search for a new position as Director General for Deepwater Operations. The idea itself would have to be brought to the board by its secretary, who is in the Energy Ministry; a global talent search would furthermore contravene the traditional presumption that only Mexicans are hired for managerial positions in Pemex—Ed.

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