EPN’s Energy Reform Package:
How to square the proposals with the historical record and investment outlook?

The debate that will follow the release of the government’s proposal for energy reform will invoke diverse claims and arguments. At the eye of the storm will be the linked topics of private-capital investment, public oversight and Pemex governance. The PAN-led, energy reform of 2008 was all about public oversight and Pemex governance; no new investment opportunities were created for Mexican or international capital.

With the clock moved forward five years, and with the development of shale gas deposits and deepwater blocks on standby, there are strong incentives for the government to think outside the box that, for two decades, has been defined by the question: How to make Pemex more efficient?

Today, no amount of “efficiency enhancements” will meet the challenges of a generation of under-investment in oil and gas and power infrastructure and a decade of falling oil and gas production.

Constitutional changes, by themselves, create neither investment opportunities, instruments of public oversight nor improvements in Pemex governance; still, they are important in setting the table for what may be proposed in the future by legislation and executive order.

Said differently, the energy package of the Peña Nieto administration is unlikely to be about private investment at all. It is more likely that the government will propose high-level measures that will not have market signals, such as the creation of a National Oil Fund (as the PAN proposes) or rewriting rules governing the career paths of oil professions in ways that would let talented specialists advance in rank and salary without having to seek jobs in management (as the PRD proposes). Another non-market measure would be the elevation of the Hydrocarbons Commission (CNH) to constitutional status as a regulator, and not, as at present, as an advisory appendage of the Energy Ministry.

If the constitutional measures are approved and implementing legislation is enacted, the table will be set for a new era of public and private investment. For this, hard choices will have to be made:

1) Reintroduce the legal figure of a concession for exploration and production.
2) Reestablish the right of a private party to own oil infrastructure.
3) Reestablish a wholesale market in electric power.
4) Create new, state-majority, commercial corporations with a minority of common shares in a major stock exchange (thus allowing private investment by portfolio managers).

In the discussion to follow we offer a perspective on legal, historical and policy issues that will need to be addressed in evaluating the government’s energy proposal. We build on the several reports issued by Mexico Energy Intelligence in 2013 on the options for energy reform in distinct market segments.

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How the government’s proposal will be seen

The government’s proposal itself will be seen very differently by politicians, journalists, business analysts and lawyers. Among lawyers, there is likely to be a big divide between Mexican and international practitioners: the former will see proposals for legal and constitutional reform in relation to the history and politics of Mexican jurisprudence; while the latter will look for assurances that investors, on the oil side, will have a mineral interest in production, and, on the power side, commercial rights over generated electricity.

Politicians from the PRI and many from the PAN will argue that the proposals strengthen Mexico’s energy security, economy and sovereignty, while others will argue the reverse.

In the language of chess, the proposal will more like *castling*. As political opponents will realize, however, castling is a defensive measure in preparation for an attack, and they are likely interpret the proposal as *check*!

Journalists may be told to follow the loudest voices.

Many of these claims and counter-claims will concern Mexico’s legal and industrial past, especially the history of the oil industry. As with many things in life, the history of the oil industry in any given legal regime may be divided into two parts: that period in which a private oil mineral right existed, and that period in which it did not. In Mexico’s case, such a right existed from 1884 to 1958, and it did not from 1959 to the present. For this periodization to make sense, an understanding of the nature and purpose of an oil mineral right is essential.

We shall also want to consider PAN’s motives in wanting to modify Constitutional Article 28, a path that the government’s proposal is also likely to follow.

The concept of a private oil mineral interest

There is confusion in Mexico about the nature of a private oil mineral interest, as the concept itself is not even discussed as such. You could say that it has been out-shouted by the precept in Article 27 that all mineral wealth belongs originally to the Nation—adding that the dominion of the Nation is “inalienable” and “impresscriptible” (two terms the legal definition of which would leave all but one in a thousand citizens speechless).

The idea refers to a legal interest in production, where “legal” means that it can be enforced in court. A concession that conveys a private mineral interest does not confer “ownership” in any conventional sense of the term (as in the ownership of a house or automobile). In the first place, the mineral interest is bounded by time (which could be 30 years, but not forever); in the second place, the interest-holder, to be able to enforce his interest, must be in compliance with all manner of laws, regulations and fiscal obligations.

So there is something right when Mexican politicians say that the oil is the property of the Mexican people (which it is, in an absolute sense); that said, in order to develop oil resources the government may choose to deploy the capital, technology and management skills of private parties, paying them as a percentage of production (or in cash at its market value). This “decision to deploy” third parties in major, deepwater projects carries with it the practical necessity of rewiring the laws that would convey a private mineral interest to the investor.

From 1884 to 1917 the private oil mineral interest was conveyed automatically to the owner of the surface land; but in 1917, in Article 27, the oil mineral interest was made conditional. A valid private oil interest would require a concession from the State. This requirement of Article 27 led to two decades of back-and-forth between the authorities and the oil companies. The oil companies, in response, said
“Fine. You surely don’t mean to apply Article 27 retroactively? We bought our oil properties in good faith under existing law.”

Mexican authorities, among themselves, may have said, “The oil companies act as if the Mexican Revolution had never taken place. It is in the nature of social revolutions that property rights change.” The authorities offered to compromise: An oil company would receive a concession for a property on which it had done a “positive act” to demonstrate its intent to develop the oil resources, and a concession was offered for a period of 50 years. The government rightly did not want vast acreage with oil prospectivity to stay in private hands without an active development program.

The oil companies hesitated too long before accepting the government’s proposal. They worried that the oil industry as they knew it, could not survive under the new rules. As future decades would show, however, the oil companies would prosper gloriously under rules such as Mexican authorities were offering—only, ironically, they would not be prospering in Mexico. The oil companies had burned their welcome.

It remains to be seen if that welcome mat will be again extended to the private oil company on the basis of offering a mineral interest in production (and, by extension, reserves).

**Why does the PAN want to change the Constitution for the sake of energy reform?**

In its discussion of the historical background to its proposal, the PAN observes that the Expropriation of 1938 did not eliminate the legal figure of a private oil mineral interest. The Oil Law of 1940, enacted while President Lázaro Cárdenas was still in office, allowed for the Mexico’s oil resources to be developed by private parties under a concession regime. A company could be paid in cash or as a percentage of production.

The enforceability of a contract for a “percentage of production” is equal to having an oil mineral right in that production.

The PAN is proposing that Mexico return to this regime that was in force for nearly three decades, that is, between 1940 and 1958. It was in the Oil Law of 1958, issued on the last working day of the presidential term of Adolfo Ruiz Cortines that eliminated, as a matter of law, the private oil mineral interest. It did so indirectly, by requiring all work by third parties in the oil sector to be contracted by Pemex, and by proscribing payment indexed to production. This small clause continues to have profound consequences sixty years later.

Counter-intuitively, the PAN proposal does not mention this law or its controversial sixth article. It focuses instead on the constitutional amendment that was promoted by Mexico’s first neoliberal president, Miguel de la Madrid, who, among other accomplishments, had a master’s degree in public administration from Harvard. As president, he promoted an economic package to strengthen the State’s control over the economy. One of his measures was to introduce the distinction between “strategic and “priority” economic areas; where the former would be restricted to activities exclusively performed by the State. This distinction was introduced as a constitutional amendment, and, in accordance with this principle, a modification of Article 27 of February 3, 1983, included oil, electricity and petrochemicals (see insert).
The PAN does not object to the concept of economic activities that are to be reserved to the State; on the contrary, it proposes to add to that list the administration of the national electric grid and the administration of an Oil Fund.

The PAN proposes to remove from the list of State-reserved activities the following: Oil and other hydrocarbons, electricity and the State-reserved petrochemicals (see insert).

To make such a proposal is a huge step toward clearing the legal underbrush away in order that market-based thinking has room to develop; but the approval of this measure would not, alone, open new investment opportunities for private capital.

For the oil side at least, the abrogation of Article 6 of the Petroleum Law would reestablish the principle of a private oil mineral interest, which, as mentioned, existed in Mexico from 1884 through 1958. In PAN’s energy reform package of 2008, there were amendments to the Petroleum Law of 1958 (and even to Article 6); but the ban on a private oil interest was untouched.

The PAN realizes, however, that any legislation that would erase the restrictions of Article 6 of the Petroleum Law would be immediately provoke a constitutional controversy—as opponents in Congress would ask for a ruling by the Supreme Court as to the constitutionality of the law.

It follows that the PAN’s energy reform strategy is only partially revealed: Once an amendment were passed that eliminated from Article 28 the precept that the State is the unique commercial actor in oil and gas, electric power and specified petrochemicals, at that point the PAN could propose a modification of Article 6 of the Petroleum Law.

PAN’s proposal regarding Article 28 may also be seen as a stratagem to serve as a line of long-term political defense against the possibility that a future presidential administration could change the law back to its present, anti-market form. Additionally, the PAN understands that a “constitutional reform” would play well in the US and international media.

**An innovative way to encourage shale gas development**

In 2008, when the PAN energy reform was enacted, an interest in developing shale oil and gas deposits did not exist. For the Mexican government, as well as for Pemex, the need to attend to shale oil and gas formations grows larger daily; however, the legal, policy and commercial path by which to develop these resources and, simultaneously, to upgrade Pemex’s skills is far from clear.

In North America, where gas prices are low and high-tech, fracking drilling costs are high, it is doubtful that any traditional oil and gas company would have an interest in investing in Mexico’s shale gas formations on the basis of a fee/BOE plus reimbursable expenses.

But a business case might be made for an investment opportunity built on the basis of a concession in which the taxes and royalties levied by the State would vary inversely with the percentage of production that would be directed to electric power generation. If private EP
companies could produce gas on their own accounts, then gas pipeline companies would be in a position to lay gathering and transportation lines that would be anchored financially, not by Pemex or CFE, but by the concession-holder. With an additional tax incentive, new power generation capacity could be built to utilize the new streams of shale gas (see figure).

**Pemex as a carried partner in concessions**

In oil producing countries with a National Oil Company, a common requirement is for the concession-holder to reserve a percentage of equity for the NOC (such as 10%). The NOC would be “carried,” meaning that he would not contribute money toward the cost exploration costs. In the event of a commercial discovery, however, the NOC would have the choice as to whether or not it would increase its equity (to as much as 25%), but on the condition that it contribute proportionally to costs, and assume, proportionally, liabilities.

In the present case, it would be unwise for the government to promote any kind of equity venture between Pemex or CFE and a private developer in any segment of the oil or power industries. Why? Pemex and CFE are both deeply embedded components of the Mexican federal government, and it would be to expect the impossible to suppose that valid market signals could come from the commercial activity of a government agency. Proposing government equity in new infrastructure investments would be to go backwards in time.

A different case, however, could be made for joint equity investments between private parties and new, state-majority, stock-bearing companies with minority shares offered to the public. It would be a bold policy move for the government to create a new NOC (a Pemex EP, S.A.) for the purposes of

1) preparing for it to operate abroad, in the fashion of Statoil, Petrobras and many other NOCs; and
2) giving a market meaning to any future equity position in concessions in Mexico.

Such a measure would bring about two benefits: With geological luck, good management and a competitive regime of royalties and taxes, it would generate a revenue stream that would help capitalize the new state-majority company; secondly, Mexican management of the new NOC would be graded on its performance by its minority shareholders in Mexico and abroad.

In such an arrangement, each partner would contribute, proportionally, royalties to a future Oil Fund (as the PAN proposes) and would pay taxes on profits, proportionally, to the Finance Ministry (SHCP). In such a world, it would be these new, state-majority companies that would have their own budgets and operational autonomy.

In order for such a proactive policies to succeed, however, the government will have to make a serious commitment to rewriting, not only the Constitution and implementing legislation, but also the national narrative about the past and future of oil and electric power in Mexico.

Contact:

George Baker
Publisher, Houston-based newsletter MEXICO ENERGY INTELLIGENCE

g.baker@energia.com

=1 (713) 255-0000
+1 (832) 434-3928 (send text message for call-back)
Benchmarking Expectations for Mexican Energy Reform (Part IV): Corporate Governance and Public Oversight

This report is the fourth in a series on benchmarking expectations for market-oriented reforms in the energy reform that has been announced by the Peña Nieto administration. This report examines the difficult topic of corporate governance and public oversight in Pemex, which was the principal concern of the 2008 Energy Reform. At present, there is no clean line between the two functions, a situation with high opportunity costs. In several places we follow the recommendations of the OECD in its confidential report of September 1, 2010; for example, the removal of all cabinet ministers from the Pemex board.

Benchmarking Expectations for Mexican Energy Reform (Part III): Downstream

This report examines reform ideas that could be embraced by the Peña Nieto administration that would introduce market dynamics into the downstream segment of the oil and gas industry. One idea is to deregulate the retail price of gasoline in selected neighborhoods, to learn about the price elasticity of the demand for gasoline as a social product.

Benchmarking Expectations for Mexican Energy Reform (Part II): Midstream

This report examines three levels of reform that could be considered by the Peña Nieto government: Lite, Plus and Heavy. The first would require Pemex Gas to offer Unbundled Service on selected segments of its pipeline to any qualified user in an Unbundled Services framework. In a deeper reform, the legal concept of First-Hand Sale (VPM) would be eliminated with two justifications: the lack of a constitutional foundation and the severe economic distortions caused by having the State control all end-user prices. A yet heavier reform would be to exclude PGBP from having equity or business control of new pipelines.

Benchmarking Expectations for Mexican Energy Reform (Part I): Market Dynamics

One useful way to understand the evolution of the Mexican economy in general and the development of the energy sector in particular is to view the period since 1959 as a Import Substitution Strategy. In late 1958, the Congress passed a new Petroleum Law that effectively eliminated the legal figure of a private oil mineral interest. In so doing, one of the four elements for a successful oil industry was removed: private economic incentive. The other three elements—talent, technology and financing—were to be sought via a STEM curriculum at the IMP and IPN, CONACYT scholarships, IMP research and foreign debt.

The Logic and Options for Energy Reform in Mexico

As candidate in 2012 and as president in 2012, Enrique Peña Nieto has indicated that he will seek an energy reform. What ideas for energy reform have circulated in Mexico during prior administrations? Tables 1-4 of this report offer a 16-page catalog of those ideas. Table 1 lists ideas already put into practice; Table 2 are ideas that were not implemented; Table 3 are ideas from civil society, and Table 4 are ideas that have been voiced in public and private venues by the global oil and power industries. The report argues that Pemex and CFE should be prepared for roles as operators outside of Mexico. One conclusion is that if a reform only makes Pemex more efficient in Mexico, it is not worth the effort.