

MEXICO'S UPSTREAM GOVERNANCE

CNH'S Cautionary Notes for the Peña Nieto Administration

THE SCENARIO-FROM-HELL is the one in which the status quo in the energy sector continues, but in the guise of energy reform. In that scenario, most of Mexico's oilfields, prospective acreage, pipelines and facilities remain under the administration of Pemex, but under new legal appearances. Where, before, public tenders for contracts that would be paid in cash could be designed in such a way as to favor one bidder over another; in the future, the selection process for joint ventures or farm-outs that would be paid in oil could be similarly designed.

This report draws on conversations during the February in Houston, Mexico City and elsewhere to construct recommendations and considerations that the Hydrocarbon Commission (CNH), as the agency of public oversight of Mexico's oil and gas patrimony, might give to Energy Secretary Pedro Joaquín and to President Enrique Peña.

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CONCLUSIONS

- ✓ The outcome of the oil reform should be that a number of top-tier oil companies come to have licenses to operate in Mexico *independently of Pemex*. This is the *sine qua non* of success. This success will bring benefits to *the economy as a whole*, not just for the energy sector.
- ✓ To ensure the introduction of a competitive framework, the CNH should reserve a percentage of the blocks requested by Pemex for future bidding by others in Round One.
- ✓ The success of the energy reform will not be measurable by the joint ventures or farm-outs into which Pemex enters. The arrangements that Pemex makes should be motivated by a vision to become an international operator *outside of Mexico*. This vision will be subverted if associations are undertaken as a defensive strategy to remain king-of-the-hill, but only in Mexico.
- ✓ It is premature to allow Mexican companies to be the operators of Mexico's oil and gas fields.

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RECOMMENDATIONS

- 1) In the upstream, the government should concentrate on creating a critical mass of international companies—with attention given to the super-IOCs—with direct, stand-alone contracts with the State and without Pemex involvement in any form. This vision is quite distinct from that of Brazil, which mandates a 30% equity stake by Petrobras in the new blocks. For Mexico, Colombia is a better model; and, unlike Pemex, Ecopetrol owns blocks in the U.S. Gulf of Mexico.

Success metric: IOCs invested in Mexico in blocks without Pemex.

Pemex should be prohibited from being a bidder, either alone, or in association with others, in the initial rounds of public tenders (or auctions) for blocks.¹

- 2) Given a realistic horizon of two years before auctions for such contracts will be feasible, it is vital that Pemex's ability to seek partnerships with these same companies be restricted to only a small percentage (such as 25%) of its awarded onshore fields and those in shallow water. During this initial period, Pemex should not be given approval for joint ventures or any other type of association with international or Mexican companies in reservoirs in water depths greater than 500m.

- 3) It is clear that Pemex intends to ask the CNH to be awarded blocks in the Perdido Area, but there are sound arguments for not acceding to this request, if not in its entirety (on account of its inflated resume of qualifications) then in part (to preserve an area in which private industry could invest in Round One, and, thereby, to be able to benchmark Pemex's costs and results).

On its own, Pemex cannot develop the Perdido Block.

To give Pemex commercial rights to an area that, on its own, it cannot develop is to needlessly circumvent the clear intent of the reform, which is to match talent with resources in ways that promote positive externalities and backward and forward linkages.

- 4) Closely monitor Pemex's proposals for associations with other companies in the Mexican upstream, especially in relation to the legal figure of farm-out.²
- 5) In relation to the form of a contract, preference should be given to the license, as that form most clearly establishes operational, financial and responsibility. Consideration should be given to a holiday for international license-holders in relation to royalties and taxes. The goal is to obtain investment commitments by major IOCs, commitments that will convey to global

¹ A repetition of the CRE-permitted joint venture between **El Paso Corporation** and **Pemex Gas** [PGPB] in the Samalayuca pipeline project in the late 1990s is to be adamantly avoided.

² A farm-out is analogous to a subcontract, in which the outside company will be paid in oil or cash for its share of production, with an over-ride given to Pemex.

markets a positive judgment of the fairness of Mexico's regulatory and fiscal system. Rent-seeking is secondary, at least for an initial period.

- 6) In relation to the criteria for making awards, the usual rules for government procurement need to be suspended, at least temporarily. There are at most two dozen international oil companies some of which must approve an investment commitment to Mexico in order for the entire exercise to be regarded as successful. Having investment commitments from overnight- or third-tier companies will accomplish nothing.

The government must use what is called a "restricted public tender," and invite the participation of just those companies in blocks that correspond to their market niches. Once a list of qualified bidders is established, the cleanest method would be to award a block to the highest bidder if a cash payment (and without introducing, through the back door, some version of "lowest price"). Proceeds from the auctions could be divided between CNH (for the training of regulators and inspectors) with the remainder allocated to the new Sovereign Oil Fund (for work-study fellowships abroad for Mexican petroleum engineers and geologists and upstream R&D).

- 7) For the success of the public tenders (or auctions), it is essential that CNH have operational control of Pemex's upstream database as well as of cartographic information about platforms, under-water pipelines and other facilities. The CNH should also be given copies of all contracts for oilfield services.
- 8) In relation to the posting of reserves, the term "expected benefits" is ambiguous. Authorities in the energy and finance ministries should interpret the law to permit quantification in volumes, and not limit state enterprises and licensees to financial or (worse yet) heat-content representations. To deviate from international practice by excluding standard representations of oil reserves in barrels or natural gas in cubic feet or meters is to sing the old song of *Mexican Exceptionalism*. The CNH should be responsible for aggregating all reserve postings, including those of Pemex, to provide the government and society a national accounting.
- 9) Consideration should be given to the creation of a corps of internationally trained inspectors who would be qualified to carry out unannounced, on-site inspections of the platforms and facilities of all operators, including Pemex.
- 10) Finally, consideration should be given to defending the CNH commissioners against the popular opposition that their decisions will most certainly provoke in some segments of Mexican society. The government is asking the commissioners to act in ways that contradict Mexico's National Petroleum Narrative. In this narrative, Mexico's energy security—amen, its pride—depends on having Pemex in the center of the national conversation about oil and gas production, reserves and policy. Such a narrative does not square with the granting of licenses to IOCs, especially since, counter-intuitively, the Congress chose to leave in the prohibition of "concessions" in the constitutional Article 27. Some members of society will doubtless view our decisions about licenses as violations of that proscription.

WHAT SHOULD THE CNH TELL THE NEXT GOVERNMENT?

Repeal the CNH Act of 2008, draft a new law for CNH 2.0

This report is the second in a series that asks about what the incumbents of a public institution in the energy sector should advise the transition team of the government that will take office on December 1, 2012. An earlier report (Market Note 118) considered the Energy Regulatory Commission (CRE). In a formal report, the Hydrocarbons Commission (CNH) should inform the transition team that the Hydrocarbons Commission Act of 2008 has imperfections that cannot be repaired by amendments to the law. The best course is to repeal the present law, and rewrite and issue a new one. The Act was created with the best of intentions: to establish a technical counterweight to Pemex that could provide public oversight to the largely self-regulated activities the national oil company. The evidence of more than three years, however, demonstrates that this goal cannot be performed without crossing the line between regulation and corporate policy. Further, there are Pemex activities that should come under scrutiny by the Commission but which, as if by tacit agreement, are presently off-limits to CNH review.

The present report offers a case study of an area of Pemex operations that should be regulated, but at present is being ignored by the CNH: the nominal, lowest price award criteria for Pemex’s full-cycle E&P contracts. Other areas where the law can be improved are identified.

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Draft License Agreement for Mexico

Embedded in a new oil regime

A PIVOT POINT occurred in the public discussion of energy reform in Mexico when the government proposed a profit-sharing arrangement with international oil companies: the law that has governed Pemex contracts since 1958 in Article 6 of the Petroleum Law forbids any compensation in kind or as a percent of production. To propose profit-sharing is to unmistakably introduce new notions in the Mexican oil sector: *compensation to be measured by percentage* (and not by a fee, as in the current Pemex contracts) and *shared risk* (presently implicit).

Of yet greater weight was the implication that new contracts would be executed outside of the procurement rules of Pemex. Such a contract has not been signed since the mid-1950s; so a full execution of this new strategy would require a new oil regime.

What should a new oil regime look like to build bridges of commerce, culture and public oversight between Mexico and the U.S. Gulf of Mexico? It would seem that in the PAN and PRI there is consensus on 2 fundamental points:

- ✓ For a serious oil reform to take place, there are items of “old business” that need attention. Chief among them is the correction of an ambiguity that the government has promoted since 1958 in relation to the topic of ownership of Mexico’s oil. To correct this ambiguity, the amendments to Articles 27 and 28 that were put in place during the period 1958-87 need to be removed.
- ✓ Top-tier IOCs should be given access to Mexico’s 500,000 km² of prospective acreage in the deepwater areas of the Gulf of Mexico. Other IOCs should be offered a commercial framework that would motivate them to invest in the exploration and development of Mexico’s considerable shale oil and gas resources.

This report examines the institutional and commercial implications of a policy of reengagement by Mexico with the global oil industry. Some, but not all, of these implications have reached the level of public debate.

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5177 Richmond Avenue, Ste. 525

Houston, TX 77056

(832) 434-3928 (text/cell)

Mailing Address:

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