

## MEXICO’S ENERGY REFORM IN RETROSPECT, PART I

*What should Enrique Peña Nieto tell his successor about the oil reform?*

**I**N THIS REPORT, we imagine a confidential memorandum by President Enrique Peña Nieto to the successor who will follow him on December 1, 2018. The memorandum is imagined as an informal document intended to help his successor navigate economic, political and institutional issues during the administration of 2018-24. The structure of the memorandum is in two sections: successes and concerns in the oil sector. A second report will address the same topics in the electricity sector.

Our view is that the Energy Reform of this administration is essentially finished, with the important exception of the retail motor fuel market, which will undergo political and social jolts in 2017-18 as the government allows prices to rise—by the unusual logic of removing subsidies on taxes.

The motive for casting this analysis as if the incumbent President of Mexico were its author is to emphasize our conviction: only the President has the sufficient moral authority and social license to revise the national petroleum narrative in ways that would better serve society, the economy and investors.

The energy reform of 2013-16 was carried out without change in that narrative. In 2013, the authority of President Lázaro Cárdenas (1934-40) was invoked to justify overturning the failed statist model of Mexico as a one-company oil town (Pemex’s). It took over a half-century (1955-2013) for that failure to be corrected. Today, the outdated narrative undermines the full potential of the new model that welcomes investment in areas of commerce previously reserved to the State.

We conclude that market-oriented revisions of the Constitution, laws and regulations are necessary but insufficient. Mexico’s anxious, resource-centric narrative must undergo parallel changes of the kind that will require the leadership that the President of Mexico can uniquely provide.

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### SUMMARY

#### SUCCESSSES

- 1) Promulgated constitutional changes that abrogated the Petroleum Law of 1958 that had excluded private investment in the upstream.
- 2) Strengthened the authority and expanded the mandate of the Energy Regulatory Commission (CRE) and National Hydrocarbon Commission (CNH).
- 3) Restructured Pemex, creating subsidiaries with commercial mandates, and allowing Pemex to seek equity partners in its leases (Farmouts).
- 4) Divested the pipeline division of Pemex under a system operator (CENAGAS).
- 5) Established a Hydrocarbon Safety Authority (ASEA).
- 6) Established a Petroleum Revenue Accountability Fund (FONDO).
- 7) Held four public auctions of onshore and offshore leases of petroleum blocks.
- 8) Held a public auction for a working interest in a Pemex lease (Trión).
- 9) Liberalized the retail market in motor fuel, allowing for non-Pemex branding of service stations and the private importation of gasoline and diesel.
- 10) Did all of the above without a popular backlash that could have included protest marches and disruptions of the kind seen following the disputed outcome of the presidential elections of 2006.

#### CONCERNS

- 1) An outdated petroleum narrative that leads to laws, regulations and contract terms that reflect fears of a political backlash and a distrust of oil companies as responsible investors.
- 2) A failure to recognize that an oil company is a technology innovator, not a plumber that is merely “extracting” liquids from an underground barrel.
- 3) Sub-optimal outcomes in many of the lease auctions.
- 4) Sub-optimal imposition of “zero discretionality” on the CNH.
- 5) Sub-optimal framework for technology innovation.
- 6) Inadequate legal structure and corporate governance for Pemex.
- 7) Inadequate safety guidelines and compliance model for deep-water operations.
- 8) Unnecessarily complex regulatory structure.
- 9) Limited career potential for Pemex professionals in a homogenous workplace limited to Mexico; inadequate international workplace experience.
- 10) Disruptive market and political signals caused by the over-involvement of the President of Mexico in Pemex’s affairs.

George Baker  
Publisher

Worse, in neighborhoods in which natural gas service exists, LPG companies notoriously bribe local officials to make it impossible to obtain the permits to lay pipelines and they bribe plant managers not to switch to natural gas. A case in point is the explosion of LPG at the children's hospital in Cuajimalpa in 2015 caused by a human or mechanical error during the process of delivering fuel. There was needless loss of life and property, given that, as we were later to learn, the hospital had been offered natural gas service, which, by far, is much safer, but the plant manager had rejected the offer.

## CONCLUDING REMARKS

CANNOT EMPHASIZE ENOUGH that if the national narratives regarding oil and gas and electricity are to change, it will be uniquely the responsibility of the President of Mexico to lead by what he says and does and by what he doesn't say and doesn't do. To begin with, he or she needs to take three giant steps backward from appearing in the media with anything having to do with Pemex or CFE. It's of particular importance that the person who has the privileges to serve as President of Mexico not cultivate personal relationships with the executives of Pemex or CFE who in the past and today who are characterized in the press and *vox populi* as "friends of the president."

*The president must lead in changing the oil narrative*

Our predecessor, Vicente Fox, took the liberty of skipping for three of his six years in office the annual commemoration of the expropriation of the oil industry. Good for him. Some of us hoped that he would make it official policy; but we were disappointed to see that he could not resist getting in the media by attending the commemoration ceremony of March 18, 2006.

Efforts need to be made in public education in order to modernize and demystify the history of the oil and electricity industries in Mexico.

It is by no means clear yet that the implementation of the Energy Redesign of 2013-16 will lead to the emergence of energy markets. Rome was not built in a day, and much more will be learned in the regulations of the implementing legislation and in the wisdom and patriotism shown in the appointment of regulators, commissioners and board members. By referring to patriotism, I mean someone who is willing to put the long-term welfare of the country ahead of his or her personal patrimony and career prospects in the public service.



### About this report

This report draws on our reports issued since 1995 regarding the evolution of the oil and electricity sectors in Mexico. Our understanding has been enriched by recent conversations in Texas and Mexico with persons in industry, government and academia.

From Bangkok, Sr. Limpiador, our copy editor and one of our upstream advisors, reviewed two successive drafts of the text and logic of the report, offering numerous suggestions.



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