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Outlook for Mexican Oil and Gas: Policy, Commerce and Corporate Governance

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DISCLAIMER

- In this presentation there will be a number of critical assessments of the petroleum narrative of Mexico as well of the institutional attributes of Pemex, Mexico’s national oil company. An attempt will be made to locate Mexico’s oil sector in historical, cultural and international coordinates.
- The purpose of these remarks will be to suggest how the oil expropriation of 1938 set in motion events that have put Pemex at a disadvantage compared to international oil companies, principally by the cutting off of trade relations (in the broadest sense) with them.
- In reaching these conclusions, I rely on conversations with Pemex careerists over three decades, as well as public data, field research and interviews with oil company country managers and government officials in Mexico.
- There is no intent here to engage in what is known in the press as “Pemex bashing,” a political art form practiced in Mexico, the U.S. and elsewhere since the oil boom in Mexico of the 1970s. “Pemex bashing” insinuates incompetency and corruption, which is not at all the intent of these remarks.
- My goal here is to invite a broader, more sympathetic understanding of the historical, cultural, economic and ideological forces that have thus far limited
  - a) the potential development of Pemex as an international oil company, and
  - b) the contribution of the oil sector to Mexico’s economic development.

The "Otherness" of Mexico (1 of 2)

Weak countries who are Great Power Neighbors adopt the political terminology and institutional structures of their natural predators <u>in order to conceal their existence and motives</u>.

- ✓ Mexicans easily recall the losses of Texas and California.
- ✓ The Texan nickname, "Lone Star State," is a permanent reminder of the disloyalty of American immigrants in the 1830s.

In 1824, Mexico adopted the language of representative democracy; but for the next 150 years government was anything but democratic; 70 years (1929-2000) Mexico had a One-Party (PRI) State

- The outer wrapping of Mexican politics takes place in familiar U.S.-style language—*presidente, partido, congreso, senado, elecciones, voto*—but these terms explain very little about how decisions are made or about how public institutions operate.

The "Otherness" of Mexico (2 of 2)

In relation to the energy sector, for causes not fully understood-- Mexico turned inward:

- On account of its hermetic, Soviet-like, "5-year-plan" philosophy of energy policy, Mexico has become the odd-man-out in oil policy the Americas; and, by comparison, Cuba is liberal.
- Mexico is the only democratic state that is a net oil exporter where the prices of all energy products are set by the State.

Iron Laws of Mexican Energy

[Low Profile's] First Law: *From an industry perspective, Mexico's oil sector is interesting only in relation to international practices and expectations.*

Schmidt's First Law: *Mexico is the paradise of simulation.*

Gayok's First Law: In *Mexico, never take "yes" for an answer.*

BAKER'S LAWS OF MEXICAN ENERGY

Baker's 1st Law: *Mexico was never meant for the English language: All descriptions in English are work-arounds.*

Baker's 2nd Law: *The future of the Mexican energy sector is clear; it's only the present moment that is so confusing.*

Baker's 3rd Law: *The American Government is the primary enabler of Mexico's non-market energy system.*

Baker's 4th Law: *It is the American taxpayer who is the portfolio investor and lender of last resort in the Mexican oil patch.*

Baker's 5th Law: *It is Mexico's National Energy Narrative that is the principal obstacle to a market-oriented reform in the energy sector.*

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A Century of Mexican Oil in 10 Dates

1894 – Mining Law—Grants mineral rights to surface owners, sparking a 30-year oil boom.

- In 1922, Mexico becomes the 2nd largest oil exporter (after the U.S.)

1917 – Article 27 of the new Constitution back-pedals, declaring mineral rights belong to the State.

1938 – The government steps into a labor dispute and expropriates all foreign oil interests.

1949-51 – Risk contracts are granted to 12 small American oil companies (e.g., Pauley Petroleum).

A Century of Mexican Oil in 10 Dates

1958 – Congress passes a restrictive Petroleum Law;

- *Article 6 eliminates production sharing agreements (PSA)*

2000 – First PAN government elected (Vicente Fox)

- *Creates high—but false—expectations of an upstream opening*
- *In 1999, Fox, as governor of Guanajuato, told the Council on Foreign Relations that he would privatize Pemex if elected president*

2008 – PAN Energy Reform legislation

- Controversial election of Felipe Calderón in 2006; weak mandate
- *10 weeks of senate hearings in the summer of 2008*

2010 – Procurement Rules for Pemex are published

- *Known by their Spanish initials: DAC*

2011 New round of Pemex public auctions for blocks

- Initially the redevelopment of three onshore blocks
- Future auctions for Chicontepec and deepwater

Evolution, Trade and Oil Policy

- Trade has had a role in human evolution: The exchange of merchandise brings about the collateral effects of cross-fertilization of ideas, technology and the accumulation of a critical mass of learning, innovation and inquiry.
- In some cases, there have been retrograde movements in technology and learning when global trade routes are cut off, as in the aboriginals of Australia (See *WSJ,* May 22-23, 2010).
- *Let's apply these observations to Mexican oil:*

  1) An unintended effect of the Mexican expropriation of the oil industry in 1938 was a cutting off of "trade" between Pemex and international oil companies.
  2) By 2008, Mexico would lose 3 generations of intellectual capital formation as well as the institutional vehicles of innovation—namely the oil companies as investors, partners, employers and conversationalists.

Pemex vs. International Practices

Topic	International practices	Mexico and Pemex
Role of upstream regulator	Yes	No (CNH is a technical advisor to the Ministry)
IOCs add to nat'l prosperity	Yes	No (national sovereignty is undermined)
Shares in stock market	Yes	No (sharply limits market feedback)
Global hiring of talent	Yes	No (except as consultants)
English as standard	Yes	No (except top 3 levels)
VP Exploration	Yes	No (a staff, not a line, position)
Peer Review in exploration	Yes	No (a top-down culture in Pemex discourages disagreement; no peer review of prospects)
Joint equity ventures	Yes	Not yet in upstream (a few downstream)
PSA permitted	Yes	No (Article 6 of Petroleum Law)
CEO with full authority	Yes	No (President appoints Pemex 2^{nd} level)
Oil production in deepwater	Yes	No (10 DW wells in 10 years; only gas finds)
Union members on board	No	Yes (5 of 15 members)

Omertà in Mexican oil policy

- Many of the top officials in the Mexican government are PhDs in economics from U.S. and European universities.
- YET, none publicly disavows the non-market system of government pricing for energy products—despite the high opportunity costs of the present, Soviet-style restrictions.
- Investigative journalism scarcely exists in Mexico.
- Mexican academics keep silent about the proverbial elephant in the living room.
- “Reform” in Mexico is undefined, but is understood to mean new top-down “efficiencies,” not market pricing
- Thus, the National Oil Narrative goes unchallenged at home or abroad.

The Energy Reform of 2008

- Rewrote the Pemex Administration Law:
  - Added 4 independent corporate board members (confirmed by the Senate)
  - Established a committee system for the corporate and subsidiary boards of directors
  - Established a loophole to let Pemex contract for services outside the Public Works and Federal Procurement Laws
- Gave the Energy Ministry a role for policy development for cross-border oilfields
- Created a National Hydrocarbons Commission (CNH)
  - As technical advisor to the Energy Ministry

Energy Reform of 2008 – What was left out

- Unlocking of the upstream and midstream potential
  - The restrictions of Article 6 of the Petroleum Law were untouched
  - Proposal to open oil pipelines and storage to private investment was defeated
  - Nothing to promote deepwater development
- International securitization of a minority percentage of shares of a restructured Pemex (as with Statoil and Petrobras)
- Granting full executive authority to the CEO, with job tenure based on performance (not, as at present, on presidential cycles)
- Reduction of the number of union members from Pemex's corporate board (only their relative voting power was lessened by the addition of the four new board members)
- Creation of a true upstream regulator that would serve as the interface between the State and the IOCs

Mature Field Bid Round

- A contract specimen available in English since November 2010
- Formal tender began March 1, 2011, for the redevelopment of 3 onshore, mature fields
- Pemex held its road show in Houston March 8th
  - Pemex seeks operating companies who will work as contractors to Pemex and be paid on the basis of a fee/barrel and partial cost recovery.
  - The contractor is paid out of an escrow account that is funded by after-tax cash flow from production
  - The qualified bidder who quotes the lowest fee/barrel wins.

Comments on the contract model

- A huge improvement over the model of the Multiple Service Contract (MSC), which paid the contractor on the basis of a price list for services.
- But the “Iraqi Model” of a fee/barrel poses multiple risks.
- The Pemex program seeks niche players with a flair for field redevelopment; unlikely that a major IOC will participate in the bidding (none did in the MSCs).
- Resistance from prospective operating companies may be expected on multiple grounds:
  - No market upside
  - No booking of reserves
  - Payment from after-tax cash-flow

Outlook

- Investment opportunities with market-pricing options: very few (example, imported marine diesel)
- Policy: No signs that the National Oil Narrative and its assumptions are being challenged; the high opportunity costs for the oil and power sectors will continue. As for power, all sales are "public service"
  - No wholesale market in power
  - No ISO (Independent System Operator)
- Pemex hopes that success in the Mature Fields program will lead to cognate programs for Chicontepec and deepwater: *Estamos en Veremos.*

Conclusions (1 of 3)

- Mexican "Exceptionalism"
  - Mexican society has over-invested in its supposed uniqueness.
  - Economic development, global competitiveness and the creation of human capital are thought to be achievable by central planning without global hiring, market pricing signals or IOCs as full partners.
- What's "clear" about the future of the Mexican energy sector is that this vision is unsustainable.
- What's "confusing" is the *how?* and *when?* the centralized-planning model will give way to a market perspective.

Conclusions (2 of 3)

- The 2nd-best logic of "First-hand Sales"
- The use of international indexes and a state monopoly in all links in the natural gas value chain is your only choice, absent
  - natural gas transportation lines that compete with those of Pemex
  - A willingness by Mexican industrialists to turn away from a blind, brand-loyalty to Pemex as a supplier
- Until then, you simulate the effects of competition by the use of price indexes in competitive markets outside Mexico.

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Conclusions (3 of 3)

- Whom did the "Clinton Rescue Package" rescue?
  - *It's was the high-interest, short-term, dollar-denominated bond-holders in New York and London, Stupid.*
- An invisible part of the Mexican non-market system is its financing at premium rates. Lenders are confident—from the Clinton precedent—that if something goes wrong, the bet will be covered by the U.S. taxpayer.
- *What has to change? Al parecer,* the non-market, in-Mexico-but-financed-abroad system will change only when
  - Pemex oil revenues drop sharply, or
  - Lenders reassess the risk that their lending policies will drive the customer to a Dickensonian poor-house.

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Por su atención, muchas gracias

For follow-up, call or email

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