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Mexico's Oil, Gas, and Energy Policy Options

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The difficulties Mexico faces in making decisions on oil, gas, and energy policy are essentially political, not technical. This does not make the problems easier to resolve; indeed, it makes them harder to deal with because technical issues can be approached head on, whereas political obstacles, rooted in the structure of government and society, can be surmounted only by means of complicated strategies. Technical operations of Pemex (Petroleos Mexicanos), Mexico's government-owned oil monopoly, are entangled in political considerations foisted on the company. These contribute to Pemex's low productivity (or, phrased differently, the company's excess employment for the output generated) and its periodic corruption scandals. What follows will deal with Pemex's finances, which are unbelievably complex and chaotic because of political, or should I say extraneous, demands placed on the company.[1]

Pemex, for some years now, has lacked funding to engage in sufficient exploration to find new sources of oil and gas. Deepwater exploration, which is expensive but where the prospects of significant findings are promising, has not been undertaken for want of money. Pemex also lacks the technical expertise for deepwater drilling, but this could be hired if the funding were available. Exploration is urgently needed because at present rates of use Mexico's proven reserves of oil will last only about 12 years. Mexico already imports a considerable amount of natural gas, and the country is in the process of converting the fuel for most of its energy generation from oil to natural gas. The domestic shortage and the high cost of imported gas is reducing the competitiveness of Mexico's high energy-using businesses. But there may well be much gas to be found in the deep waters of the Gulf of Mexico.

There are three main options for dealing with these problems: seek private, necessarily largely foreign, sources of investment for oil and gas exploration and exploitation; reduce the amount of Pemex revenue the government takes for its own budgetary needs; or continue to muddle through and hope for the best. The third option is stated pejoratively, even though the government did luck out in the 1970s when new oil output came on stream; however, running a government based on an assumption of repeated good fortune is hardly a rational choice. Carrying out the first option involves running roughshod over deeply held emotions stemming from Mexican history, which led to setting up a government-owned monopoly in the first place after foreign owners of oil companies in Mexico rejected government requests. The second option would require changing the entrenched Mexican habit of low tax collections to relieve Pemex of being the cash cow for one-third of the federal government's budgetary needs.

With respect to the fiscal option, the current situation is as follows: Mexico now collects between 11 and 12 percent of gross domestic product in taxes; this amounted last year to about $80 billion. Pemex provided about 6 percent of GDP, or $40 billion, to finance the government budget. If the revenue take from Pemex were reduced by, say, one-half, this would leave Pemex with roughly an extra $20 billion for its own needs. Pemex now obtains much of its needed funds from borrowing and is not in a position to increase borrowing much more. Pemex also obtains appropriations from the central government, but this is an uncertain and variable source. Further government appropriations for Pemex might be feasible this year and next because the government calculated its revenue from oil based on a price of $27 per barrel for the Mexican oil mix, and the actual average export price has risen to almost $40 per barrel. This kind of financing may not be available year after year.

In other words, in order to let Pemex keep an extra $20 billion each year, tax collections would have to rise by at least that amount—and probably more, because a budget of 18 percent of GDP is inadequate to meet the need for better education and health care and a safety net for the old and the poor. The question of privatization could be finessed for now *if* Mexico were able to let Pemex operate as a normal company using its own earnings to make and carry out its own investment decisions. The "if" is a big one, but many Mexicans prefer this option in order to keep oil in Mexican hands. Earlier in its history, Pemex was able to make investments from its own revenue even after paying federal taxes, but this has not been the case for several decades.

The Mexican Congress recently passed legislation to reduce the taxes Pemex pays as of January 1, 2006. The bill is complex and the tax imposed on Pemex would vary with the price of oil and gas, but it was an effort to address the

problem of Pemex financing. The early indication is that President Vicente Fox will veto the bill, presumably because it does not specify how the Treasury would get the revenue needed to make up the shortfall that would result. The president has until September 1 to act on the bill. If he does exercise his veto, a two-thirds majority in each chamber of the Congress could override it.

Choosing the other option of permitting private investment does not require the privatization of Pemex, only a willingness to allow joint ventures between Pemex and private interests, including foreign direct investment. Mexico would still own the oil in the ground, but the private investment would permit a risk-reward model that does not now exist. This model exists in Canada and Brazil and other countries that have government-owned oil companies. Action like that of Argentina, where the government-owned oil company YPF (Yacimentos Petrolíferos Fiscales) was completely privatized in 1995 during the Menem administration, is not necessary in Mexico. The Brazilian and Canadian models are working well.

The Mexican government could, of course, do both: relieve Pemex of some of its tax burden so that it can operate as a normal oil company; and also accept private-public joint ventures, especially for expensive deepwater exploration. When I last discussed the issue of deepwater drilling, several Mexican officials and experts said they hoped it would be possible to identify a suitable site that straddled the territorial waters of Mexico and the United States, thereby permitting a joint venture that did not require a constitutional amendment, obviating the need to face the controversial and emotional issue of private investment in Mexico's oil and gas resources.

The dangers Mexico faces are running out of oil both for domestic use and export in a relatively short period; of having to meet a growing bill for natural gas imports; and of failing to provide energy to all would-be users, or providing it at a cost that is so high as to encourage producers to move to locations where energy is cheaper. Unless good fortune intervenes, the decisions will probably have to be taken in the new administration that comes into office next year. Mexico has shown that it is able to make controversial decisions when it looks as if there will be economic hardship if nothing is done but economic benefit if long-standing policy is revised. One good example of this was the abandonment of import substitution policy—keeping high import barriers in order to protect domestic industries—following the financial collapse in 1982. This led to lowering import protection, joining the General Agreement on Tariffs and Trade, and later entering into the North American Free Trade Area with the United States and Canada. The two issues, trade protection and permitting private risk ventures for oil and natural gas, do not have the same emotional resonance in Mexican history, nor is trade policy a constitutional issue But both require the readiness to adapt when the economic well-being of the population is at stake.

The internal debate on oil, gas, and energy policy is going on, as the recently approved bill on Pemex shows. The head of Pemex has declared that he believes policy change is urgently needed. President Fox tried early in his administration to change tax policy, but he failed to make headway because of congressional opposition. The debate may take on new resonance in the campaign for the presidency once it moves into high gear later this year and early in 2006, but a frontal argument in favor of change is unlikely. Those who seek change will probably seek to frame the debate around economic growth and meeting the country's social needs, while the opponents will likely emphasize the constitutional question of accepting private investment and advocate spending cuts rather than raising tax collections. The presidential candidates are apt to discuss the future of Pemex but dance around the policy issues involved.

It would be hard, probably suicidal in terms of winning an election, for a presidential candidate to run on a platform that goes against a history of shunning foreign investment in the oil sector or that favors raising taxes. Carlos Salinas did not run in 1988 on a platform of free trade with the United States. He came to that position subsequently, when it became evident that the needed foreign investment for development would not come from Europe, or elsewhere, without a welcome mat of legal assurance for investment in Mexico and the promise of the large U.S. market. In hindsight, it is clear that Salinas chose the right moment for his free-trade initiative; and he made his case on economic development grounds.

It is hard to predict when these two fundamental criteria—the impending energy shortage and the proper timing—will become simultaneously evident to the Mexican public. Unless something unforeseen happens soon, such as a new oil find or discovering a large deposit of unassociated (i.e., not associated with oil) natural gas, the timing for some action to change oil, gas, and energy policy will probably come some time after the 2006 election, but during the next presidential *sexenio* (six-year term).

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[1] The May 2005 *Issues in International Political Economy*, no. 65, dealt with this theme of politics dominating oil and gas policy in many Latin American countries.