Mexican Energy Reforms and Opportunities for India

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Mexico for long has enjoyed a position among the top Crude oil producing countries of the world. The reserves are still estimated to be abundant however, with usage of the same sites over a protracted period of time and the use of out dated technology; the output of Crude oil has dwindled.

Mexico has the tenth largest crude deposits in the world. It has realised over the past few years that this gift is not being taken advantage of by Mexico in a way that it should have been. Despite the deposits, Mexico still imports about fifty percent of the total natural gas it needs due to lack of competent refineries in the country.[1]

Mexico has traditionally been an energy supplier to the US; however, as the US becomes more energy independent by the day, the Mexican exports to the US have shrunken and so have the revenues for Mexico. Mexico is now looking to expand its export base and has started looking towards countries like India and Japan.[2]

India, at the same time, has been trying to diversify its energy exporters. Mexico provides India with a welcome break from the Middle-East that has conventionally been the oil exporter to India.

Mexico has now catalysed the entire process by implementing reforms in the energy sector that have opened up this sector to private players from the national and international arena. India, with its expertise in refining crude and its need to find newer sources of energy supply, has seen these energy reforms as a wonderful opportunity.

This would also be an opportunity for both India and Mexico to strengthen their bi-lateral ties.

The state owned Oil enterprise Petroleos Mexicanos or Pemex has for long exercised a monopoly over all hydrocarbons and its derivatives in the country. The roots of this monopoly can be traced through history and eventually lead to the Mexican constitution as will be explained further in the issue brief.

With declining output of Crude oil and dwindling revenue from it, Mexico has felt a need to introduce advanced technology and inject more capital into the exploration and production of the country's oil reserves.

In 2013 the Nieto regime introduced a series of energy reforms aimed at re-invigorating the energy sector of Mexico.

The Reform

The reforms are multi – pronged and cover legal, financial and operational realms of the upstream, mid stream and downstream activities of the Mexican oil and gas sector.*[3] It also alters the traditional way of functioning of the Mexican oil and gas industry. The reforms aim at reducing the state control of the industry and inviting foreign investments and privatization. The scale and nature of the energy reforms announced in 2013 are unprecedented and this is due to the strong tradition of resource nationalism in Mexico. Resource nationalism has been a vital part of the political and national psyche of Mexico and till the recent constitutional amendment; was apotheosized in article 27 of the Mexican constitution. The amendment required a two-third majority in Congress in addition to a majority in state legislatures. The nationalization of oil also has deep historical significance for the Mexican people. Therefore these reforms are not purely economic decisions but have considerable social and political significance attached with them.[4]

The tradition of oil nationalism and state ownership of Hydrocarbon resources can be traced back to the 1917 constitution of Mexico, article 27 officially designates the state as the owner of all sub-soil resources. However it was President Lazaro Cardenas who nationalized the oil and gas industry of Mexico in 1938 that led to effective implementation of article 27. However, the state could still enter into upstream partnerships, issue service contracts and even grant complete contracts to private entities the payment of which was often made in either cash or as a percentage of the total production.

In 1958, there was an amendment made to the regulatory law, thereby giving the rights of development specifically to the state through the state owned company – Petroleos Mexicanos or Pemex. Nevertheless, foreign companies still managed to weasel through by finding legal loopholes and obtain rights of exploration and production through risk contracts. Therefore two years later the law was amended again, this time to unambiguously prohibit all concessions and contracts and banish those already existing and thus the monopoly of Pemex over all hydrocarbons and its derivatives was established.[5]

Privatization and liberalization was introduced by NAFTA or the North American Free Trade Act in the 1990's however, the Oil and Gas sector remained untouched by it. It was in 2008, during the Felipe Calderon regime that an inkling of an energy reform was introduced. "Integrated Service Contracts" were introduced and were awarded through public tenders and were paid in cash by Pemex. However due to the lack of constitutional change and limited legal certainty, the reforms could not attract the interest of serious investors and had limited success.[6]

The reforms undertaken by the President Enrique Pena Nieto have been after the modification of the article 27 along with articles 25 and 28 of the Mexican Constitution and this change has eliminated the monopoly of Pemex. However it has not reformed the proprietorship of the state over all hydrocarbon resources. Exploration and Production or the E&P sector still remains a strategic sector and is still directly under the state's directions.

The reform is aimed at altering the legal framework of 1958 and adopting a friendlier structure that encourages private sector investment. This increased interaction with the private, both Mexican and International, actors will be through three specific contract options – Profit-Sharing, Production- Sharing and Licenses and all of these three types of contracts will be awarded through public tenders[7]

However the state, through SENER or the Ministry of Energy has also kept with itself the authority to grant adjudication to Pemex whenever the state pleases. Akin to this, the state has also reserved with itself the right to establishing of a direct partnership of up to 30 percent, either via Pemex or through direct financing in case of special projects which deal with technology transfer. There is also a special clause regarding the likelihood of a trans-boundary field, here the state is required to have a minimum of 20 percent participation.

The reform will also change the structure and functioning of Pemex. Pemex will now enjoy complete autonomy from the government; the state shall still remain the sole owner of the firm but will forgo the management of the firm. The company is expected to benefit from an easier fiscal regime and will receive a financial bailout for restructuring financially as well as pension obligations. Pemex will have to incorporate the corporate governing structures so as to compete with global firms. The new Hydrocarbons law gives Pemex two years to transform itself.[8]

This time the reforms due to constitutional amendment behind them have given it a legal certainty that international players seek before investing.

Three types of contracts that will be awarded through public tenders as previously mentioned are – Profit- sharing, Production – sharing and Licensing. The difference among these contracts is based on the compensation that will be given to the investors. Profit-sharing contracts will compensate the bid-winner with a percentage of profits in cash, production-sharing contracts would compensate in kind with oil, gas or condensates. In contracts that are based on licensing , the investor will receive the property rights of hydrocarbons once they are extracted from the subsoil and till then will remain the property of the Mexican state itself.

The type of contract on offer for each bid will be determined by SENER on a project-by – project basis. The compensation to the state will also be determined in a similar fashion and this is predicted to be the most significant cost variable for public tenders. For contracts based on licensing the signing bonus will also be determined that is to be paid when a bid is awarded. The flexibility in contracts has been incorporated as a way to ensure that the investments and tax regimes match the specific characteristic of each field, thus maximizing the benefit to the state.

The reform also describes in detail the three other payments applicable on all contracts. Two of these are an exploratory phase fee and a basic royalty, which will be payable to the Mexican Petroleum Fund for stabilization and development. The third fee would be the contribution to the Fund for Hydrocarbon- Producing States and Municipalities, a monthly flat tax for performing E &P activities based on a set fee per square mile.

It is also important to note that companies in the Oil and Gas sector will receive a different treatment when it comes to taxes. The deductions claimed for the Impuesto Sobre la Renta (ISR), Mexico's traditional corporate income tax, will be subject to different rates to those applied in other sectors of economy. An advantage to all E&P companies is that all royalties, fees and compensations directly derived from these contracts will be exempted from the 16 percent Value Added tax.[9]

One can see that reform strives hard to strike a balance between encouraging private sector investment and extracting the most amount of oil rent possible from the interested parties.

The reform is being introduced in stages and the first stage was announced on 13th August 2014. In the first stage of reform the Mexican government has announced the areas that will be open for exploration and production for private investors. This stage has been termed round one and is divided into two broad categories. The first is called 'Farm Outs'. This category contains joint venture opportunities for private investors that want to exploit the sites that have been allotted to Pemex. The other category is termed 'New Fields and Reservoirs', this is when investors opt for exploiting fields and reservoirs that are not allotted to Pemex. The reserves that are not under Pemex were chosen by the government on the basis of their potential to increase Oil and Gas production in the short run, which is ultimately aimed at increasing revenue for the state and doing it quickly. it is expected that the latter category of reserves will see investment based more on licensing and production sharing contracts as opposed to profit sharing ones.[10]

The Farm Outs will be distributed through public bidding that would be supervised by the CNH or the Comision Nacional de HydroCarburos. These Farm Outs can be translated to the development of 1.56 BBCOE or Billion Barrels of Crude Oil Equivalent of 2P reserves. 2P can be better understood as Proven and Possible Reserves. These Farm Outs also represent 2.66 BBCOE of 3P reserves (Proven, Possible and Probable) reserves. The Farm Outs are spread across an area of 236 square miles and is expected to bring in an investment of $32 billion USD within the next 5 to 10 years.

The New Fields and Reservoirs will be a more ambitious category as compared to Farm Outs; it has 169 sites that would be put up for bidding. 109 of the total are labelled as exploration projects; these sites are spread across an area of 10,000 square miles and are estimated to have 14.6 BBCOE. Assessment states that these sites would require investments amounting upto $19 billion USD over the span of next four years. The rest 60 sites are ready for production and are spread across an area of 1000 square miles. They are said to have 3.8 BBCOE in 2P reserves and will require an investment of $15.1 billion USD spread across the next four years.[11]

To ensure transparency in the entire process of bidding by private companies and to keep the decisions based purely on economics, the bidding processes will be regulated by two main bodies – the Secretariat of Energy or the SENER and the National Hydrocarbon Commission or the CNH. Transparency in the bidding and the subsequent processes is a big concern for Mexico. Dr. Ken Medlock, an Energy and Resource Economist at Rice University, Texas, commented that Pemex was one of the most inefficiently run bodies of the Mexican government, specifically because the Mexican federal government was in the habit of using up the assets of the company without giving a second thought to the running of the organisation. To increase the level of transparency, all meetings would be televised live and would also be accessible on a public website – www.Ronda1@gov.mx.[12]

It has also been estimated that this boost to the energy sector would soon trickle down to the other sectors and start having an impact there. It is believed that by 2018, the Mexican GDP would see an additional one percent being added to it and there would be the surge of an extra two percent in the GDP by 2025. It has also been appraised that these reforms would prove to be the harbinger of good news for employment in Mexico. The year 2018 would bring with it an additional half a million job opportunities for Mexicans and by 2025, the number of supplementary employments would increase by two and half million. These changes would also mean cheaper gas and electricity for the people of Mexico. Such promises and projections have been a cause of hope for the common Mexican people also, along with the Mexican government that has been battling an almost stationary rate of growth for the past thirty years.[13]

Opportunities For India

India is an energy dependent country and 78 percent of the total energy requirement of the country is met through import of energy resources[14]. The dependence on Crude Oil specifically has steadily grown over the years, from 43 percent in 1990 to 71 percent in 2012[15]. Traditionally the Middle East has been supplier of Crude Oil for India however, now India has started to look towards diversification of its import base.

The attempt to diversify the import base can be exemplified by the fact that Nigeria has recently become India's biggest supplier of Crude Oil replacing Saudi Arabia from the position[16] .

The Latin American market as a whole and Mexico specifically provides an alluring opportunity for India to expand its import base.

Similar sentiments are echoed by the Indian Petroleum minister Dharmendra Pradhan who on his two day visit to Mexico where he held bilateral talks with his counterpart Minister of Energy of Mexico Mr. Pedro Caldwell[17] said "India is trying to diversify its import sources of energy and more than 20 per cent of crude oil import is presently sourced from Latin America," he also said, "Mexico figures high on the priority of India to enhance bilateral energy ties."[18]

Mexico has become more lucrative as a business partner after the reforms as it now offers opportunities for partnerships in exploration and production. This would lead to a change in the nature of the relationship between the countries from that of a producer and consumer to energy partners. It is also a well – suited opportunity for India as India has emerged as a Crude refining hub in the recent past and a chance to participate in Exploration and Production of Crude oil will give India a chance to take advantage of its expertise.

Indian petro-chemical companies have already taken notice of the developments in the region and have been quick to act. The international wing of the state owned company, ONGC – ONGC Videsh has decided to open an international office in Mexico.[19]

ONGC Videsh recently announced that India has been attempting to diversify the sources of its crude oil and believes that at least 20 percent of all the crude demands of India must be met by the Latin American region. They also went on to say that to make this possible, Mexico featured high on the list of possible sources of crude oil.

The geographical distance from Mexico has been considered an obstacle in trade traditionally as it is considered that the vast distance would translate to very high costs of shipping. However, in recent years, there has been softening in the costs of shipping and transportation. The bigger advantage that Mexico offers over is cheaper crude oil, which also compensates for the distance and increased cost of shipping.

Import of Crude oil from Mexico has begun and it has been observed that the total cost comes to about $7-10 USD lesser per barrel in comparison to the oil imported from the Middle-East. This difference in the cost of the crude provides an advantage over oil from the Middle-East that has been the traditional supplier of Crude to India. [20]

The Indian private sector has also given quite an enthusiastic response to the opening up of the Mexican Energy Sector. At present, the Indian Oil Company, ESSAR and Reliance Industries buy around six million tonnes of crude oil from Mexico annually.

Some contracts for Exploration and Production in the Farm Outs category have already been signed with Pemex by Reliance.

This tilt towards Latin America in general and Mexico specifically will echo with India's Focus LAC Programme. Under the Focus LAC (Latin America and the Caribbean) India is trying to establish better trade links with the continent as the Ministry of Commerce estimates that the markets of Latin America and the Caribbean offer great potential for trade. The Programme estimates that Indian trade with Mexico would grow by 4 percent annually. This growth in trade will also lead to a strengthening of bi-lateral ties between the two countries. Such conditions will facilitate a growth in energy trade, thereby making Mexico a favourable energy – trading partner. [21]

Conclusion

Mexico has opened up its energy sector to the international market. It is a welcome step to revitalize the dwindling production of its known and exploited resources and a chance to explore and exploit the many hydrocarbon resources that have remained hidden and undeveloped.

It is an opportunity for Mexico to increase its rate of growth, give a push to its economy, enliven its markets and reinvigorate the job market.

These reforms have also come at an opportune time for India. India has been trying to diversify its oil import portfolio as the country imports 78 percent of its total crude oil needs. Mexico provides India with an alternate to its traditional oil import partners and, at the same time, provides India with the opportunity to participate in the exploration, production and processing of hydrocarbons. It is an interesting opportunity for India that should be taken advantage of by furthering our relations with Mexico and moving towards energy security.

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The Views expressed are that of the Researcher and not of the Council.

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