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## Meeting Mexico's Energy Needs - Reconciling Sovereignty with Economic Development

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# Meeting Mexico's Energy Needs—Reconciling Sovereignty with Economic Development

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## I. Introduction

President of Mexico Vicente Fox, has announced that one of the priorities of his administration will be the development of the energy sector. He is well aware of the current need for investment in this sector, particularly in power generation and non-associated gas exploration and production. He is also aware that the government will not have the necessary funds to match the anticipated growth in energy demand. However, under the actual political scenario in Mexico, his intentions to develop the energy sector have faced strong resistance from opposing political parties.

The Mexican Constitution reserves to the state, generation, transmission, and distribution of electricity as a public service.<sup>1</sup> The Constitution also reserves to the state the exploration and production of all hydrocarbons located in Mexico.<sup>2</sup> Under the current legal regime, there is very little room for private investment in this sector, and the necessary funds for its development will have to come from the federal budget, unless legislation is passed to allow some form of private participation.

The energy sector plays a very important role within the national economy. It provides three percent of the Gross National Product, represents eight percent of the total

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1. Constitución Política de los Estados Unidos, [MEX. CONST.] art. 27.  
 2. *Id.*

Mexican exports, and provides thirty-seven percent of the federal income. The Mexican federal government spends 56 percent of its yearly budget on energy-related investments. However, it is foreseeable that the energy sector will need a total of 139 billion dollars of investment over the next seven years, to match the growing demand which includes: 59 billion in electricity, 40 billion in oil exploration and production, 21 billion in natural gas, and 19 billion in refining.<sup>3</sup>

President Fox's challenge is to find alternatives to attract private investment in this sector. Last December, Fox's political party, Partido Accion Nacional (PAN), presented to Congress an initiative to amend the Constitution to allow private investment in the electricity industry. The political mood in Mexico, has not been conducive to the proposed constitutional amendments, and the Chamber on Constitutional Issues of the Senate dismissed PAN's initiative last April.

Both, the Partido Revolucionario Institucional (PRI), and the Partido de la Revolución Democrática (PRD), have submitted to Congress their own proposal to reform the electricity industry. These two initiatives are very similar, and do not pretend to modify the Constitution to allow private investment. On the other hand, they are intended to avoid any type of privatization and strengthen the state-owned monopoly. These two initiatives will be discussed in Congress in the near future, and will probably raise strong political debates.

Additionally, last year President Fox issued amendments to the *Reglamento de la Ley del Servicio Público de Energía Eléctrica* to increase the amount of excess power that private generators could sell to the state-owned utilities. A group of Congressmen, including PAN members, filed a constitutional challenge before the Supreme Court, accusing Fox of exciding his presidential authority. The Supreme Court recently ruled that the amendments were unconstitutional.

The new democracy that the Mexican people voted for in the past elections, is becoming the largest obstacle that President Fox will have to overcome to modernize the energy industry. Vicente Fox, the first non-PRI president in seventy years, is facing a divided Mexican Congress, and a Supreme Court that is now acting as a truly independent judiciary power. President Fox's proposed changes to the energy sector touch on sensitive cultural and political issues within the three political powers, that was not common in Mexican recent history. However, the development of the energy sector is dependent upon Fox's ability to reconcile the differences that exist today in the Mexican political scenario.

## II. Basic Legal Structure

### A. OIL AND GAS INDUSTRY

The oil and gas industry was nationalized in 1938. Since then, the industry has become a matter of national pride; and a symbol of the wealth and patrimony of the Mexican people. It is considered a strategic activity by the Mexican Constitution, which means that it is strictly reserved to the state. No private participation is allowed, with few exceptions.

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3. "Programa Sectorial de Energía 2001-2006," D.O., 11 de Enero de 2002 [Energy Sector Plan 2001-2006].

The Nation has the exclusive right to:

- Explore, exploit, refine, and process crude oil and natural gas.
- Produce basic petrochemicals and liquid petroleum gas (LPG).
- Carry out first-hand sales of those energy products.<sup>4</sup>

The Mexican government carries out all activities related to the oil and gas industry, through the state-owned *Petroleos Mexicanos* (Pemex), and its four vertically integrated subsidiaries: *Pemex Exploración y Producción*, *Pemex-Refinación*, *Pemex Gas y Petroquímica Básica*, and *Pemex Petroquímica*.<sup>5</sup>

Private participation in the oil and gas industry is very limited. Basically, private parties may participate in this sector only in the capacity of contractors through construction, procurement, or service contracts with Pemex or any of its subsidiaries. Pemex may enter into contracts with private parties; however, by law, all contracts must be paid in cash, and may not be paid through a participation, or percentage, in the production or results of the operations.<sup>6</sup>

## B. ELECTRICAL INDUSTRY

### 1. Strategic Activity

The electricity industry was nationalized in 1960. It is also considered a strategic activity, strictly reserved to the state by the Mexican Constitution; however, there are a few exceptions. The Mexican Constitution reserves to the Nation, the exclusive right to generate, transport, and distribute the electricity as a public utility (public service).<sup>7</sup> These activities are carried out by the federal government through the state owned *Comisión Federal de Electricidad* (CFE) and *Luz y Fuerza del Centro* (LFC).<sup>8</sup>

Private participation in the electricity industry is limited. In 1992, the Electric Utility Law was amended to allow private parties to own and operate:

- Generation and cogeneration plants for self supply of electricity.
- Generation plants to sell the electricity to CFE (Power Purchase Agreements awarded through public bid procedures).
- Generation plants for exports.
- Facilities to import electricity for self supply purposes.<sup>9</sup>

Private parties may not, however, generate electricity to sell it directly to third parties as a public service.

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4. Ley Reglamentaria del Artículo 27 Constitucional en el Ramo del Petróleo art. 4 [Regulatory Law of Petroleum].

5. Ley Orgánica de Petróleos Mexicanos y Organismos Subsidiarios art. 3.

6. Ley Reglamentaria del Artículo 27 Constitucional en el Ramo del Petróleo art. 6 [Organic Law of PEMEX and Subsidiary Entities].

7. Constitución Política de los Estados Unidos Mexicanos, [MEX. CONST.] art. 27.

8. Ley del Servicio Público de Energía Eléctrica, art. 7 [Law of the Public Service of Electric Energy].

9. *Id.* art. 3

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## 2. Energy Regulatory Commission (CRE)

All power generated by private parties requires a generation permit granted by the *Comisión Reguladora de Energía* (CRE), upon fulfilling all technical standards.

The CRE is a part of the Energy Ministry. It has technical and operational autonomy, and is in charge of regulating both public and private operators in the power generation and natural gas storage, transmission, and distribution industries.<sup>10</sup> The purpose of the CRE is to promote efficient development of the energy industry, taking into consideration the disparate interests of participants and consumers. The CRE currently faces the challenge of regulating both Pemex and CFE, the state-owned monopolies that control the two respective markets.

### III. Investment Needs and Opportunities

According to the Energy Ministry, Mexico, for the next seven years, needs 139 billion dollars of investment in the energy sector: 59 billion dollars for electricity; 40 billion for oil exploration and production; 21 billion dollars for natural gas; and 19 billion dollars for refining.<sup>11</sup>

#### A. PRIVATIZATION OF THE ELECTRICITY INDUSTRY

In 1999, then former President Ernesto Zedillo submitted to the Mexican Congress, an initiative to amend the Constitution to allow private investment in the electricity sector, including the sale of the assets of the state-owned companies, CFE and LFC. Unfortunately, Zedillo's initiative was not adopted by Congress, due to strong opposition from the labor unions and other opposing political parties.

Zedillo's initiative was based on the estimate that Mexico will need over 27,000 megawatts of additional power generation capacity by 2009 to avoid a power crisis in the country. The federal government will have to spend over 59 billion dollars in power generation infrastructure, to meet the estimated demand for electricity by 2009. Zedillo realized that the investment needs were so great, that the only logical solution would be to amend the Constitution to allow private participation and sell the state-owned assets.

When President Vicente Fox took office in 2000, he announced that one of his priorities would be to modernize the energy sector through private investment. However, he was very clear in assuring (perhaps mindful of Zedillo's prior failure) that the state-owned companies would not be privatized.

Last December, members of the Senate from President Fox's political party, filed with the Mexican Congress, an initiative very similar to the one submitted by Zedillo, except that this initiative clearly stated that the assets of the state-owned companies would not be sold, and the labor rights of the employees of the state-owned entities would be respected. Unfortunately the PAN's initiative was dismissed by the Chamber on Constitutional Issues of the Senate, which decided that any reform of the electricity sector based on amending the Constitution, would not be adopted.

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10. Ley de la Comisión Reguladora de Energía, arts. 1, 2 [Law of the Regulatory Comisión].

11. Programa Sectorial de Energía 2001–2006, D.O. 11 de Enero de 2002.

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### 1. *PRI and PRD Initiatives*

In March and April of 2002, the PRI and the PRD, respectively, submitted to Congress their own proposal to reform the electricity industry. These two initiatives were submitted as a counter-proposal to the PAN's initiative. The PRI and PRD intend to modify the rules applicable to the state-owned monopolies to make them more efficient, without any Constitutional amendment.

The common idea between the PRI and PRD is to implement the Constitutional principle that the State is responsible for the generation, transmission, and distribution of electricity as a public service. Therefore, they both propose new regulations for the state-owned utilities to make them more productive and self sufficient. The PRI and PRD intended to give the CRE additional authority to impose heavy regulations on the state-owned utilities, to treat them like productive corporations, and simulate competitive market conditions for the benefit of all users.

Under these two initiatives, private parties would still generate electricity for self-use or cogeneration projects, but rules for these purposes would be changed to prevent private parties from avoiding the Constitutional principles. Today, industrial users are permitted to form a corporation for purposes of obtaining a self-generation permit. Stockholders of such corporations may receive electricity as a purely private generation project. This mechanism has allowed several industrial and commercial users to form self-use groups, and build power plants for their own supply. Power companies have used this method to supply electricity to users and make a profit. From the PRI and PRD perspectives, this is contrary to the actual Constitutional principles.

The PRI proposes to eliminate the possibility of self-use groups formation. In other words, self-use and cogeneration permits would only be granted if the electricity was to be delivered to one single user. The PRD proposal is not to eliminate self-use groups; rather, it is to create rules under which every user is allowed to receive electricity, in proportion to the capital contribution made to the corporation holding the generation permit. These two proposals, if implemented, would prevent power companies from competing against the state-owned monopolies.

However, the reality is, that under the actual self-use generation groups, the state-owned utilities have fewer burdens to invest in generation capacity to supply large industrial users. Perhaps the biggest question that may be raised for the PRI and PRD, is how are the state-owned utilities going to finance the 59 billion dollars needed in the next seven years to develop the industry without incurring public debt?

### B. PEMEX MULTIPLE SERVICES CONTRACTS (MSCs)

Another area of the Mexican energy sector that is in urgent need for investment, is exploration and production of natural gas. The expected growth in electricity demand implicates the need to increase production of clean fuels. Most of the power plants under development will be fueled by natural gas.

On December 6, 2001, Pemex announced the beginning of a process to increase the production of nonassociated natural gas. It is estimated that the natural gas demand in Mexico will grow from 4.3 billion cubic feet per day (Bcf/day), to nearly 9 billion Bcf/day in the next decade. The only ways to avoid natural gas shortages would be to: (1) import natural gas from the United States; (2) import Liquefied Natural Gas (LNG) from Asia, Africa, or South America; or (3) accelerate domestic gas development and

production. Among the three alternatives, the most economically viable is to increase national production. However, since exploration and production of oil and gas is reserved to the state, and no participation or ownership of the reserves may be offered to the contractors, Pemex has come up with a new strategy to hire specialized companies to perform a wide variety of services under a single contract, the Multiple Service Contracts (MSCs).

Under the MSCs, a contractor or a group of them will be responsible for performing multiple services under a single contract (including drilling wells, installing gathering pipelines, conducting field operations). The contractor will not have any ownership of the reserves, or the production, and it will not participate in the value of the production or the benefits from exploitation. The contractor will be responsible for obtaining the financing for the total capital investment and the operating expenditures, and will be paid a service fee based on a percentage of the measurement point value of the production.

Pemex has taken the position that the MSCs are not concessions, production sharing contracts, or risk agreements; rather, MSCs are purely service contracts, because they do not grant exclusive exploration and production rights, or ownership of hydrocarbons. These statements should be viewed against the back-drop of the constitutional limitation under which Pemex operates; and these statements are intended more to assuage political criticism, than to describe the undertakings and risks of the contractor. There is a clear risk that the payment structure (since it is practically based on the value of the new production), may be insufficient to cover costs and the agreed rate of return.

Pemex has not yet announced what the services fees or the rate of return will look like. Pemex has only said that the contractor will be paid on the basis of standard operating and capital costs, and a profit margin. In any case, Pemex is aware that this process is somewhat different to what exploration and production companies are used to, and it is concerned that there may be no interest due to the complexities and the risks involved. This is why Pemex has announced a consultation period during the first quarter of 2002, through a conference sponsored by Pemex and the Energy Ministry. Pemex is still trying to ascertain whether this new strategy will be attractive to possible investors.

Perhaps the biggest challenge that Pemex will face throughout this process, is the legal inquiries that are being raised by political parties. Some politicians have raised the concern that MSCs are illegal, since they violate the constitutional rule that the oil and gas reserves belong to the nation, and that in some way they are being compromised under the MSCs. Some opponents have also said that this is the first step towards a privatization of the oil and gas industry.

Pemex has come up with an innovative strategy to increase gas production using private funds and state-of-the-art technology. However, the question of legality remains to be resolved. This time, Pemex has brought to the edge the constitutional principles of the oil and gas industry, but appears to be confident that it has the legal arguments to support this new strategy.

Under the democratic process that Mexico is undergoing, it is possible that there may be a constitutional challenge to the MSCs before the Supreme Court.<sup>12</sup> This of course would delay the implementation of the MSCs.

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12. In May 2001, the Mexican Congress filed a constitutional challenge with the Mexican Supreme Court against a Presidential Decree, which authorized self-supply generators to sell to CFE

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#### IV. Conclusion

Since the nationalization of the oil industry in 1938, the Mexican people have developed a strong sense of pride and sovereignty around the fact that the energy industry belongs to the state. Unfortunately, this sense of pride has been used as a political tool; and now that political times have changed, it appears difficult to discuss the possibility of modernizing the industry by allowing private investment.

The challenge President Vicente Fox is facing in the Mexican energy sector, is key to his success as the first PAN President. If the energy sector is not developed at the same pace as the growth of energy demand, the damage to the Mexican economy could be serious. It is clear that the Fox Administration is aware of the situation, and is trying to take the necessary measures to avoid an energy crisis, but the question of his political ability to implement those measures is yet to be answered.

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their excess capacity without going through a bidding procedure. The Mexican Congress alleged that President Fox went beyond his authority, and usurped the legislative authority of Congress.

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