

## Mexico's Energy Policy Options in North America's Continental Energy Markets

Isidro Morales  
Universidad de las Américas, Puebla.  
Visiting professor. American University<sup>1</sup>  
[Isidro.morales@udlap.mx](mailto:Isidro.morales@udlap.mx)

Energy security entered the policy jargon of the United States (US) at the turn of the century. Although modern concerns remain the same as those prevailing in the past, (i.e. dealing with the governance of risks and uncertainties), the current strategy for ensuring security in the energy field indicates a transition era of “expensive oil”, during which both Canada and Mexico shall have the incentives for developing their unconventional and conventional resources in order to increase and/or maintain their energy supplies to the US. Although there is no consensus in North America on a shared perception of energy risks and threats, the Security and Prosperity Partnership (SPP) initiative launched by the three countries in 2005 constitutes the space through which the three countries of North America will pursue their respective interests in the energy field.

This essay shall focus only on the Mexican side of the puzzle. I contend here that in spite of the fact that Mexico's energy sector remained practically outside the North American Free Agreement (NAFTA), and that the government has consistently maintained a state monopoly in its energy resources, Mexico's oil production has been compatible with US security concerns. At present, what is at stake is the continuity of Mexico's current energy production, which could eventually mean a severe decline in its oil and gas production, with all the implications this may have for North American energy markets. This could be, in fact, the major US security concern vis-à-vis its southern neighbor. However, as I argue in the third and fourth sections of this paper, current energy policies and those that eventually could be implemented by the incoming presidential administration at the end of 2006, remain compatible with present US security concerns.

### *1. US energy security: past and present*

Energy security returned to the forefront of US energy and foreign policies when Vice President Dick Cheney released, in May 2001, the so-called National Energy Policy (NEP) of George W. Bush administration. This was before the tragic events of September that took place that same year. Energy challenges were then defined as a threat to America's prosperity and standard of living if the growing imbalance between its energy production and consumption was not tackled. The

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Cheney report advocated conservation –through technological innovation-, infrastructure development, the increase of domestic energy supplies –other than oil and gas- and stronger links with both Canada and Mexico as major policy steps to enhance the security of the country (NEPDG, 2001). After the terrorist attacks to the Twin Towers in New York and the Pentagon, and the President’s departure from deterrence to the notion of pre-emptive war in order to justify the US-led war against Afghanistan and thereafter against Iraq, it became clear that energy security was a major component of both US domestic and foreign policies.

In many ways, the concerns involved in energy security policies remain the same as those prevailing in the past; say when the “energy crisis” became the “moral” equivalent of war during the Carter years. The governance of risk and uncertainty is in fact at the grounds of any security strategy. In the case of energy, a risk is mainly defined in terms of unexpected shocks affecting the stability of energy supply (mainly oil and gas), which may be unleashed by natural depletion (the decline of energy stocks in reservoirs), natural disasters (i.e. hurricanes Katrina and Rita which skyrocketed oil prices above the 50 US per barrel in 2005) or geopolitical changes (political instability in oil producing countries, war in the Gulf, proliferation of so-called weapons of mass destruction -WMD –in a sensitive country and/or region, etc.). These supply shocks may at the same time unleash uncertainties in energy markets and undermine policy options, i.e. the evolution of oil and other energy-related prices, the entrance of alternative fuels, the evolution of new investments and drilling exploration for developing new, “out of risk” prospective areas, etc . In that sense US energy security concerns remain the same as those in the past.

However, what has changed in present years is the strategy to deal with those concerns. In contrast to the Carter years, the Bush government is not betting on the “independence” of the US economy from foreign supplies, but rather on the diversification of the domestic energy mix and the non-politicization of global energy markets (oil and gas). In contrast to the Kissinger years, the US is not sponsoring a plurilateral supply management mechanism as envisioned when the International Energy Agency (IEA) was created, but it is anticipating an increase in world oil and gas production coming from “expensive” or “non-conventional” sources, most of them located out of the Persian Gulf.

In fact, the major departure from past administrations is how the Bush government perceives and deals with the sensitive issue of oil prices. At present, high oil prices are not perceived as fueling inflation and hampering economic growth; it seems rather that the Bush administration is anticipating a new era of “expensive oil” (ranging in the low to high forty US dollars per barrel for the next 25 years), during which several energy options could become possible: the development of “non conventional” hydrocarbon resources (tar sands, synthetic oil, shale oil, cold bead methane, etc); a new boost to nuclear energy; a new boost to coal consumption as an input for electricity, thanks to technological changes that have reduced damages to the environment; the growth of renewable sources of energy and the technological feasibility of synthetic fuels. In other words, the Bush administration is betting on the transition of the oil era of the past century to a new era in which oil continues to be a major source of world energy, but mainly for

fueling the transportation sector (as a “white” distillate), among a growing and more diversified energy mix in which the entrance of synthetic oil and fuels make a breakthrough. (cf. Senate, 2005 and EIA, 2006).

The rationale by which expensive oil is perceived as an advantage rather than a vulnerability (as in the past) lay in the fact that the US economy is less and less dependent on energy intensive industries, such as cement, steel, paper, chemicals and the like. According to most recent estimates, growth in the following years will come from services industries (currently 80% of US GDP) and non-energy intensive manufacturing. This, combined with a secular decline on energy intensity ratios (i.e. less and less energy is needed per unit of GDP), and with technological innovation, a growing population and labor productivity, have shed a forecast that the US economy will keep growing at an average rate of 3% percent in real terms over the next 25 years in spite of the prevalence of high oil prices<sup>2</sup>.

Last but not least, concern about a terrorist attack to the energy network has become a new element of the energy agenda after September 11. The market mechanism alone will not guarantee the security of energy flows and interconnections. This has definitely underscored what the Cheney report sketched in 2001, the need to strengthen the links with US strategic partners in the Americas.

## *2. Toward a continental energy partnership: the main goals and concerns*

Energy cooperation in North America became a reality during the negotiations of the Canada-US Free Trade Agreement (CUSFTA) in 1989. It became even stronger during Mexico’s negotiations to build on CUSFTA and create the North American Free Trade Agreement (NAFTA) in 1994. Based on CUSFTA, Canada guaranteed energy supplies to the US<sup>3</sup>; through NAFTA, Mexico began liberalization of cross-border energy trade in gas and electricity, although maintaining state monopoly on upstream and downstream activities. Private investment was also permitted in domestic gas distribution and transportation, as well as for independent electricity producers, provided they sold their output through the national electricity network still monopolized by the state.

In 2001, consistent with the recommendations of the Cheney Report, Presidents Bush and Fox, and Prime Minister Jean Chrétien created a *North American Energy Working Group* (NAEWG), an inter-ministerial task force with the goal of sharing information and data for improving and enhancing energy trade and interconnections within North America. The meetings and publications of this

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<sup>2</sup> See EIA, 2006:63. It is important to highlight that according to the US Department of Energy scenarios, oil prices are driven by US, China and India consumption, which is supposed to keep growing due to their high economic performance. Since OPEC countries remain the residual supplies, the development of additional spare capacity of these countries remain crucial for the evolution of prices. However, EIA estimations does not take into account the de facto embargo that the US has with key oil producing countries, such as Iraq, Iran and to a lesser extent Libya. If production comes back to pre-crisis years, and Gulf countries spare capacity is increased, this will have a downward impact in oil prices, pushing OPEC policies in the defensive side, as it was during the mid eighties.

<sup>3</sup> Canada and the US agreed on severely limiting export/import restrictions, on keeping the proportion of energy exports relative to total supply, and on avoiding dual pricing.

trilateral group have become more relevant after the terrorist attacks of September 2001 and the fall 2005 hurricanes in the Gulf of Mexico. But the future of both Canadian and Mexican energy markets became reframed under a “continental” strategy once energy became a major pillar of a Security and Prosperity Partnership (SPP), launched by the three governments in 2005 (Cfr. Dukert, 2005) .

The SPP report of June 2005<sup>4</sup> calls for the creation of a “policy environment” in which a sustainable supply and efficient use of energy could be promoted. It also recognized that energy has become “critical to the prosperity and security” of the nations. Those high-level initiatives, and the growing pressures prevailing in energy markets due to a tight supply combined with natural disasters striking the US Gulf Coast, have made regional energy cooperation a priority. This type of “regional partnership” is fully consistent with current Bush’s national security strategy betting on open markets combined with regional alliances. It is also consistent with what current Secretary of State, Condoleezza Rice, has called “transformational diplomacy”, the new, post-deterrence diplomatic order that the second term of the Bush administration pretends to articulate. Through this new approach, major US goals of combating terrorism, WMD, “rogue states” and expanding democratic institutions could be better achieved through regional alliances. ( Rice, 2006)

The major goal of this North American strategic partnership, in terms of energy security, is of course to keep both Canada and Mexico reliable and safe partners of the US. Both Canada and Mexico play a major role as net suppliers of oil to the US. In 2005, the former supplied 16.3% of US gross oil imports, and the latter 15.4% (See Table 1). Both countries were the two single largest suppliers of oil to the US. Canada is the major exporter of gas to the US, providing around 15% of its domestic consumption. The fact that the energy grids of the two countries are highly interconnected with US markets (mainly in the case of Canada), makes each of these two border countries a sort of an extension of the US homeland, at least in terms of American security concerns. The US is interested not only on the steady evolution of both conventional and non-conventional sources of oil and gas in each of its North American partners, but also on the safety and integrity of any critical infrastructure conveying energy flows to its homeland.

It may be also argued that the US is highly interested in keeping, or increasing, its import share from either of these two countries in the foreseeable future<sup>5</sup>. This is so because in spite of all policy and rhetorical efforts, the US

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<sup>4</sup> Cfr. “Security and Prosperity Partnership of North America. Report to Leaders”, Trilingual Version. June 2005. [www.spp.gov/spp/report\\_to\\_leaders/Trilingual\\_Report\\_to\\_Leaders.pdf](http://www.spp.gov/spp/report_to_leaders/Trilingual_Report_to_Leaders.pdf)

<sup>5</sup> According to some authors, it is irrelevant for the US to reduce its oil imports from the Gulf producers (21.7% of its imports in 2005), since oil markets are global and fully integrated (Cordesman and Al-Rodhan, 2005). This is true in terms of the evolution of crude oil prices. Any disruption in any part of the world is immediately transmitted to all importing countries. However, in terms of strategic options, US growing reliance on “high risk” countries or areas could become a liability. Since the fall of the Shah, the US does not import oil from Iran. Washington has imposed sanctions -through oil embargos- to Iraq and Libya. If the “War on Terror” is going to last, as it has been repetitively announced by the Bush administration, Washington will be keen to keep and or increase its oil imports from “out of risk” regions.

economy will remain addicted to oil and gas in the years to come. According to most recent available scenarios, in year 2030 oil and gas will still amount to 61% of overall US energy consumption. Oil and gross imports will amount to 64% of petroleum consumption and gas imports to 21 % of overall gas consumption. (EIA, 2005:64). Thus, according to the new global strategy for enhancing energy security in the US, and the regional priorities raised by the North American partnership (SPP), it is anticipated that Washington will focus on the following issues in the years to come:

- a) The evolution of non-conventional oil (and gas) in Canada. In recent years, Canada has become a major oil power due to its huge proven reserves of tar sands, from which bitumen (a heavy, low gravity oil) and synthetic oil are obtained. With the equivalent of 178 billion barrels (BBb) (NEB, 2004: 4) of established reserves, oil sands have made Canada (mainly Alberta) the second largest reserve in the world, second only to Saudi Arabia (See Table 2). This is the equivalent to 40 years of current US oil consumption, which made of Canada the closest and safest reservoir to the US. Since Canada has liberalized its oil and gas markets with the coming into force of CUSFTA, there is no major “structural barrier” impeding the development of this major source of non-conventional oil. However, two major uncertainties loom on the horizon: the development of oil sands is feasible if oil prices remain above the 30 US dls pb<sup>6</sup>, and the additional costs that the energy industry has to “internalize” if Ottawa is to attain the goals of the Kyoto Protocol<sup>7</sup>.
- b) The development and expansion of the appropriate infrastructure in both Canada and Mexico, for enhancing oil and gas exports to the US. Due to the characteristics of Alberta’s oil sands (heavy oil that can be processed with technically upgraded refineries), most Canadian non-conventional oil will have the US as its final destination, at least in the short to mid-term. This means a further continentalization of pipelines and the upgrading of refinery processing in the US. As for gas, neither Canadian nor Mexican production will be able to supply growing US imports of gas in the short to long term, even if the Mackenzie Delta gas pipeline starts working in 2011 (EIA,2006). Thus, the sifting of Liquified Natural Gas (LNG) facilities is required in the two countries.
- c) The evolution of the investment climate in Mexico’s energy industry. As previously said, NAFTA initiated a modest liberalization in Mexico’s gas and electricity sectors. The current big question mark is whether the Fox administration, or the incoming one, will extend NAFTA treatment to other areas of the industry. From a US perspective, an enhanced participation of private companies is desirable if Mexico’s oil exports are to be sustained, and/or increased, in the medium to long term.

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<sup>6</sup> Supply costs for bitumen range on the 10 to 16 Canadian dollars per barrel, and synthetic oil ranges on the 22 to 28 Canadian dollars. Cf . NEB, 2004:7.

<sup>7</sup> Some authors have estimated this internalization cost of 6 US dollars per barrel (Brownsey, 2005:16)

- d) The security and reliability of the continental energy grid. So far, the US proposal is to transform the current North American Electricity Reliability Commission (NERC) into an organization in which Mexico will join as an observer.

### 3. Mexico's current energy quandaries

According to Mexico's Constitution and energy-related regulatory legislation, overall hydrocarbon resources belong to the State. The status of Mexican oil and gas reserves is similar, in some way, to Canada's, with the difference that in the latter country the provinces own the reserves. A major difference however, between the two countries, and of course vis-à-vis the US, is that according to the Mexican legislation the State is the only entity to explore, develop and produce hydrocarbon resources. This also includes the generation and distribution of electricity, nationwide, and downstream activities in the case of crude oil. Until 1994, when NAFTA came into law, no private participation –either national or international companies- was allowed in Mexico's energy sector, with the exception of turn-key-projects and subcontractors providing specific services to one of the two major state monopolies: *Petróleos Mexicanos* (PEMEX) and *Comisión Federal de Electricidad* (CFE).

Mexico's legislation reflects its own history, during which state energy monopolies played a major role for industrializing the country during most of the 20<sup>th</sup> century. The two companies became icons of nationalism and state-led policies promoting growth and welfare during the second part of the 20<sup>th</sup> century, by keeping domestic energy prices below international levels. Since this monopoly survived NAFTA, the Mexican government may still differentiate between national and international markets when fixing energy prices. From the early eighties up to the present, when PEMEX became a major oil exporting company, it became as well the major source of fiscal income for government (currently 35% of overall government income). From then on, all succeeding governments, up to the current Fox administration, have used this oil rent for state purposes, the value of which fluctuates with international oil prices.

In other words, the monopoly over hydrocarbon resources became a strategic tool and income source in the hands of the state for pursuing ambitious social and macroeconomic policies. The use (and misuse) of this fabulous oil rent made possible the financing of the so-called "oil boom" of the late seventies and early eighties, during which oil production almost tripled. When international prices collapsed and Mexico's foreign debt skyrocketed, the oil rent became the guarantee of the repayment of "fresh loans" that the government needed during the eighties and early nineties (See Morales *et al*, 1988). In early 2005, after the peso crisis and the financial bail out prompted by President Clinton (20 US billion in loans) was put in place, Mexico's oil rent and reserves became the backbone of the whole financial architecture.

Thus, keeping the oil monopoly in the hands of the state is a matter that goes beyond historical, nationalistic and policy considerations. For the Mexican government, the administration of an oil rent (either for the better or for the worse)

has become strategic for funding government expenditures and for backing a growing foreign debt, both from government and PEMEX. That is why no major actor within the Mexican political elite, attempting to impact Mexican public opinion, dares to claim, at least openly, a privatization of the oil sector if one doesn't want to risk one's own political career. So far, nobody has seriously raised the point of privatizing the state monopolies. What is at stake, as it will be discussed later, is whether or not to modify the investment climate in the energy sector in order to widen the scope and possibilities of private capital participation.

It is also important to highlight that Mexico's nationalistic energy policies, although they have unleashed tensions with its northern neighbor on some occasions, have never directly challenged US strategic interests. At the beginning of the 1980s, Mexico became a major oil exporter at a time when the US and other Western countries were dealing with oil shortages and price instability. At that time Mexico also agreed to sell oil to fill the US strategic petroleum reserve. In spite of a sovereignty discourse highlighting Mexico's nationalism and autonomy on energy matters, Mexico never joined OPEC and never threatened to use its oil exports as a "weapon" for getting strategic concessions from the US (Meyer and Morales, 1990).

Mexico's oil rent has always been perceived, either by Mexican political elite or by political stakeholders and public opinion, as a tool for supporting social and/or industrial policies. However, from the early eighties to the present, political elites have also used this oil rent for dealing with successive financial crises. As previously said, this was the case in 1982 during the debt default of the state, in 1986 when oil prices collapsed and more recently, in 1995, during the so-called "tequila crisis". Mexico's oil income was put on the table in order to restructure unpaid loans and to guarantee the repayment of new ones.

This may explain why during the past decade Mexico made the greatest effort for increasing its oil exports in spite of the fact that less and less public money was channeled to its energy sector. While in 1994 Mexico was still exporting 1.307 MBD, at the turn of the century exports amounted 1.603 MBD. Exports also became progressively more concentrated to the US as a country of destination, going from 73 % in 1994 to 85 % of overall Mexican exports at the end of 2004 (Shields, 2005:45). President Fox continued with the upward trend, trying to reap the benefits of a tightening international market. In 2004 oil exports reached a historical top of 1.870 MBD. In terms of value, exports income jumped from 7.517 billion US dollars (BBdls) in 1994 to 23.397 BBdls in 2004 (PEMEX, 2005). Revenues fluctuated during the past decade but have gained a new upward momentum since 2002, when a new era of "expensive oil" seems to have started.

All these trends clearly indicate that Mexico's energy policies were compatible with US interests and concerns in the oil market. However, what has become an issue in this new era of strategic "continental" partnership, is whether Mexico will be able to maintain its own energy trends, in order to consider it a reliable exporter to the US and/or the international market, and a reliable partner able to give a solution to its own energy bottlenecks while respecting its NAFTA and "partnership" commitments. Within this perspective, the main "hot issues" in Mexico's energy agenda and currently impacting the continental energy partnership

are twofold: the sustainability of current exports and the evolution of the investment climate in this industry.

*a) The sustainability and potential increase of Mexican oil exports*

The sustainability of Mexico's oil and gas production is currently at stake. During the past 15 years most investments in PEMEX were channeled to increase production and consequently, exports. If this could be explained by succeeding money-hungry governments pressed by international creditors or domestic constituencies, the final outcome was a serious decline in Mexico's proven stock of crude oil, and a deficit in gasoline and natural gas production for supplying a growing domestic demand. In 1999 PEMEX reclassified Mexico's overall stock in proven, probable and possible reserves. The taxonomy refers to the actual recovery of crude oil depending on technological and economic conditions prevailing in the industry.

Suddenly, Mexicans realized that from a total amount of reserves estimated on 57.742 BBb in 1999, proven reserves were only 24.7 BBb. Those are reserves from which current production is being obtained. In 2005 those reserves fell to 12.882 BBb, which at current levels of production will be depleted in 10 years (Shields, 2005: 53, and PEMEX, 2005). However, possible crude oil reserves amount to more than 20 BBb, most of them located in deep offshore Gulf of Mexico.

The dramatic fall down in proved reserves of the past recent years are explained by a reclassification made by PEMEX in 2003 (in order to comply with international standards), and to the inability of the company to compensate for the depletion of its stock with additional reserves. Still more concerning is the fact that most of current oil production is sustained by just one field, Cantarell, the offshore reservoir located south of the Gulf of Mexico. In 2004, 72% of oil production and 17% of natural gas came from this highly productive field (PEMEX, 2005). Experts estimate that this wealthy field is about to begin its decline, halving its production by year 2010 (Baker, 2005).

The current Secretary of Energy and Director of Pemex concede that Mexico needs to maintain annual investments reaching 10 billion dollars if Mexico's oil production is to be sustained and even increase to 4 MMbd. According to them, investments should be as high as 15 BBdls annually, or 25 BBdls during the following 12 years, if Mexico wants to increase its production to 5 or 6 BBbd, respectively. (Shields, 2005: 87)

During the Fox administration investments have in fact increased compared to previous years, reaching almost 11 billion dollars in 2004. However, since 1997 more and more of those investments are not being made by PEMEX, but by outsourcing services in drilling and exploration to private companies. Those companies raise the funding and once their services are accomplished, PEMEX starts paying them with the additional income it gets from them. This formula, labeled in Mexico as infrastructure projects whose payments are re-scheduled for public expenses purposes<sup>8</sup>, began functioning during the Zedillo years, but

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<sup>8</sup> In Spanish, this formula is called *Proyectos de infraestructura diferidos en el registro del gasto* the acronym of which is *Pidiregas*.

President Fox made it the backbone for financing new investments in the oil and gas sector.

In 2004, 90% of PEMEX overall investments were funded by private companies through this mechanism (PEMEX, 2005:8). The Fox administration has praised this investment design as the way to go if PEMEX wants to maintain and/or increase its production while maintaining the constitutional gridlocks pending in this industry. At the same time, this formula has released the government from diverting its oil rent for funding the recovery of its oil reserves and other energy-related projects. As in the past, the current administration has kept “confiscating” most of the PEMEX revenue.

From 1998 to the present, PEMEX has been operating under a financial deficit, since the Ministry of Finance levies more than 60% of the company’s revenues, in spite of the windfalls of the recent years. At the end of the day, if private investments funded through the *pidiregas* formula are not paid directly by PEMEX (because of this huge transfer of resources), they become a liability for the company or for the Mexican government. This has raised the criticism of opposition parties to this formula, because it prevents a major reform to the fiscal regime of the state company, and at the same time it has obscured the level of its indebtedness.

In fact, the way that new investments have been funded in recent years in the oil and energy sector, has unleashed a major debate in Mexico on the sustainability of the status quo or the need to look for a new investment regime in the industry. There was no agreement during the Fox administration on this, and it was debated in the 2006 presidential campaign. Currently, there seems to be a general consensus that the status quo is not sustainable. The differences explode when the debate is turned to the nature of a new investment regime for the industry. This has been very well reflected in the case of gas and power generation.

b) *The evolution of the investment climate in electricity and gas*

As previously said, NAFTA made it possible for private utilities to participate in the production of electricity and in cross-border transactions if they were small producers, or were producing for self-consumption or through co-generation. In all cases power production was understood as a surplus that a company had and that it could be traded only through the national transmission network, in the hands of CFE, the Mexican power monopoly. Changes in Mexico’s domestic regulations confirmed this situation. However, in early 1999 President Zedillo submitted to Congress a constitutional reform proposal, through which power generation would cease to be a monopoly of the state. Only the transmission network, according to this proposal, would remain an exclusive operation of the state. If the reform had been approved by Congress, NAFTA treatment would have been extended to the power sector, letting private utilities to increase their shares in a growing market (Cfr. Beltrán, 2005:152-153). The proposal was rejected, showing for the first time that a divided congress, where a party majority is non-existent, could become a major counterbalance to the Executive initiatives.

Two years later, President Fox submitted to a more divided congress a more timid regulatory reform through which private utilities could increase their market

shares in the power sector (always selling through CFE), and congressmen challenged the proposal at the Supreme Court of Justice, alleging that only the Legislative branch, not the Executive Branch, was entitled to change the legislation on the matter. This open confrontation between key legislators from the opposition and the President shaped the environment in which the Fox administration attempted to modify the investment regime of the energy sector. Albeit with a divided vote, the Supreme Court eventually supported the legislators' position<sup>9</sup>. Fox has not been successful in passing a major reform in this regard, although he submitted an initiative to Congress similar in spirit to Zedillo's and that will probably have the same fate.

Fox's proposal was submitted in August 2002 and aimed to introduce a Constitutional amendment which would entitle private power producers to generate and commercialize electricity. According to this proposal the monopoly of the state would be confined to the supply of power in the category of "public service". The proposal envisages two types of consumers, residential and small users whose power needs were guaranteed by state-owned enterprises, under the "public service" category, and big or industrial users whose need could be covered either by state enterprises or private ones. However, the proposal envisioned that the threshold distinguishing between "small" and "big" consumers would be progressively reduced, so the former could eventually access the electricity markets of private producers<sup>10</sup>. The transmission grid would remain a "natural monopoly" under the hands of the state. Under this initiative, CFE and Luz y Fuerza del Centro (LFC)<sup>11</sup> remain state companies but the transmission grid would come under the control of an autonomous public body guaranteeing the functioning and open access of the national grid.

The rationale of Fox's proposal was grounded in the need to increase power generation capacity by around 32000 megawatts (MW) in the coming decade, a capacity growth that the two state-owned companies could not afford due to their financial restrictions. The reform was also heavily needed, according to this proposal, since technological changes had reduced the construction of power plants

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<sup>9</sup> Although not being a constitutional reform, the Fox's proposal aimed at breaking the limits to which current legislation let independent producers to generate and sell their electricity surpluses to CFE. Co-generation producers, for example, would have been entitled to sell all their production to the state monopoly with no bidding process. The latter, according to legislators, was equivalent to a de facto amendment on energy legislation, because private producers were only allowed to sell surpluses and not become independent power generators. Senator Manuel Barlett (PRI), president of the Constitutional Affairs Commission at the Senate, became the leader who promoted this constitutional controversy. He has successfully articulated a nationalistic strategy for the reform of Mexico's energy sector, highly supported by PRI and PRD legislators. For the text of Fox's proposal and the decision of the Supreme Court of Justice, see, Barlett, 2003: 91-226.

<sup>10</sup> Consumption below 2500 kilowatts per hour (KWh) was to be supplied by state-owned utilities, representing around 60% of current total sales. Above that limit, consumers would be entitled to buy directly to private utilities. See Barlett, 2003: 237. The possibility of lowering the threshold would let private companies enlarge their market share to residential consumers.

<sup>11</sup> Covering mainly Mexico City and populations living in surrounding states.

and the costs for generating electricity, so private competition could be encouraged in an area which traditionally was considered to function as a natural monopoly<sup>12</sup>.

Although Fox's proposed amendments have not been voted on yet by any of the houses in Congress, members of the PRI in the Senate have already circulated a preliminary position in which the President's proposals are totally dismissed. PRI's position in the Senate has been led by Senator Bartlett, who has articulated what I could call the nationalistic vision of Mexico's energy reform. The rationale of this position embraces both technical and principled considerations. On the technical side, this "nationalistic" position dismisses the argument that CFE has not the financial capacity to respond to an increased demand in the coming years. Since growth in demand has been overestimated in official figures as well as the requirements for new investments, PRI Senate members estimate that state utilities have enough resources and capabilities for funding a more realistic growth in future demand. However, the major argument against a gradual privatization of electricity markets stems from the conviction of these senators, shared by many of the PRD, that electricity generation should still be considered a public, strategic good, and not a commodity. Private businesses should be kept out of this industry, whose main goal is to avoid profit, maintain open access to the grid and compensate through subsidies deprived social sectors. There is also the fear that a gradual privatization of the sector could eventually give to private utilities enough market power for imposing their prices, despite federal regulation<sup>13</sup>.

In the natural gas domain, what was distinctive about the Fox administration was the enlarged participation of private investors in the development of the Burgos Basin. This gas reservoir, located in northern Mexico with attractive reserves of non-associated gas, became the target of Fox's energy policies in order to abate growing imports of natural gas for that particular region. While Mexico exported marginal amounts of gas in the early eighties, at the turn of the nineties it started to import growing volumes of this fuel. Mexico still has a large amount of gas reserves, although most of them remain associated with oil or remain prospective. Furthermore, PEMEX has traditionally lacked enough transmission pipelines in order to supply the growing level of consumption from northern industrialized states, especially Nuevo León, whose capital, Monterrey, has become the major post-NAFTA industrial site in the country. Imports from Texas became more attractive than pumping gas from southern fields. When the country shifted into gas for substituting fuel and residual oil as a feedstock for producing electricity, in the nineties, demand for natural gas increased dramatically, lifting imports to 27% of current domestic consumption. If consumption trends keep this pace, imports could become 50% of overall consumption in year 2012 (Shields, 2005:63). Growing imports are perceived in the country as a failure of the state monopoly to ensure self-sufficiency and as a means for transmitting higher international prices into the

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<sup>12</sup> Fox's proposals were embodied in four initiatives, one of which aims a Constitutional amendment. The four initiatives could be access at the Mexican Senate website:

<http://www.senado.gob.mx/comisiones/directorio/energia/>

<sup>13</sup> See Barlett, 2003: 242-301. For Manuel Barlett, the privatization of electricity markets responds to the pressures of big electricity companies interested in increasing their profits and market shares, in coalition with Mexican officials interested in having a stake in the privatization process (Interview with Barlett, 2006).

Mexican economy. None the less, the government is currently anticipating that growing imports could be supplied by Liquefied Natural Gas (LNG) shipments, entering Mexico's Atlantic coast through Altamira and the Pacific Coast through Baja California. The development of infrastructure and the construction of regasification plants are being accomplished and the government anticipates that part of LNGs shipments could eventually be re-exported to the US.

This is the reason why the development of the Burgos Basin became important for the Fox administration, since this reservoir contains non-associated gas and its production could easily supply additional gas to the Nuevo León region. From 2003 to 2005, PEMEX bid what has been called Multiple Service Contracts (MSCs) for developing Burgos. MSCs continue the PEMEX tradition of outsourcing specific services the company cannot develop. However, the difference this time is that MSCs encompass several services in just a few companies to be developed in the span of 15 to 20 years. They are long-term clustered contracts. As in the past, these contracts do not allow for any share nor participation in Mexico's gas reserves or production. A fixed amount is paid for the services provided by companies on a yearly basis, regardless the output they get from the gas fields they develop. According to PEMEX's estimates, 5.9 billion dollars have been invested by private companies through this mechanism, which will let them boost gas production from the Burgos fields up to 605 million cubic feet daily (MCFD) in year 2008 (See [www.csm.pemex.com/](http://www.csm.pemex.com/)).

MSCs have been criticized, however, for several reasons. They have not attracted any of the major oil and gas companies, perhaps because they are not allowed a share of gas reserves. Since a fixed amount is paid to service contractors, the development of some fields could become more expensive than anticipated if their productivity is not high. A major criticism comes however from opposition parties, arguing that MSCs violate the Mexican Constitution, since they have let private companies to drill and keep maintenance services in exploration and production activities. This time, Senator Manuel Bartlett was not successful in challenging the legality of these operations in the Supreme Court of Justice. Nevertheless, he has attempted to block them before civil tribunals, though so far unsuccessfully (Fuentes, 2005).

The fact that MSCs have remained controversial in Mexico have further discouraged potential investors in the Burgos Basin, and heated the debate of the need to change the status quo in the energy sector of the country. The debate split in two directions: while President Fox proposed a constitutional change in order to let private investors legally and clearly participate in the exploration and production of non-associated gas, congressmen heatedly debated about the need to push a fiscal reform in order to partly reduce PEMEX transfers to the Ministry of Finance.

#### *4. The role of Congress in crafting a policy change in the energy sector*

Though President Fox was not successful in passing a constitutional amendment for opening the power sector to further private participation, this was not the case with the fiscal situation of PEMEX. The burden of need for fiscal relief for the company was shared by both the Executive and the Legislature since

PEMEX has been running on a deficit in recent years. Since the company was transferring more than 60% of its gross income to the Treasury, a tax cut was badly needed in order to raise money for needed investments and expenditures. The battle for this cut in taxes became rapidly politicized and entangled with partisan positions in both Houses of Congress. Each of them made their respective proposals in mid 2005, only to be recast after a veto coming from President Fox. The tax cut, which set the basis of a future and more ambitious fiscal reform for the energy sector, was passed at the end of 2005.

The Ministry of Finance is a strong player in the governance of Pemex's fiscal position, and was consequently opposed to any major crunch in fiscal revenue that could eventually jeopardize the federal budget. Since a "Stabilization Fund"<sup>14</sup> has been created by using additional income from oil exports sold at prices above those originally budgeted at the beginning of the fiscal year, the Ministry of Finance is interested in avoiding a major crunch in that Fund. President Fox made the passing of a fiscal cut conditional on Congress agreeing to make the administration of PEMEX more transparent and accountable. One of his proposals was to include on the governing board of the company prominent independent citizens able to give policy advice outside of the traditional stakeholders<sup>15</sup>. Congressmen took the opportunity to increase leverage either at the local or federal level. Since part of oil revenues go directly to the budgets of federal states, the Senate attempted to increase the transfers to the municipalities to the detriment of states. More contentious became the attempt of legislators to control and decide the export ceilings of PEMEX.

In the end, all major actors made some concessions in order to craft a legislative amendment guaranteeing tax cuts for PEMEX in the years to come. The new legislation released around 1.5 to 2 BBdls for PEMEX in year 2006. Future tax cuts in the years to come may reach up to 5 to 7 BBdls (nominal dollars) according to Congressional estimates. Cuts estimates were done under the supposition that PEMEX's investments will range 10 to 11 BBdls annually from 2006 to 2013, and were completely deducted from Pemex revenues before making any tax transfer. Congress also estimated that oil production will remain in the range of 3.5-3.7 MMbd during the same span of years although gas production will increase from 4869 MMcfd in 2006 to 8436 MMcfd in 2013 (Camara de Diputados, 2005). President Fox conceded to stop the enlargement of PEMEX's Board of Directors but restrained legislators from deciding the export ceilings of the company<sup>16</sup>.

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<sup>14</sup> This Fund works as a sort of financial reserve for balancing overall federal expenditures at the end of the fiscal year and guarantees that the federal government will have the budgeted income from PEMEX when exports are cut or prices go down.

<sup>15</sup> At present, five of the eleven seats in the Board are given to members PEMEX Union, who remain strongly linked to the PRI. The remaining seats are allotted to the ministries of economy, energy, finance, environment, communications, transport, and foreign affairs, all of them appointed by the President, including the director of PEMEX. This clearly shows how oil and gas policies are heavily intertwined with political interests.

<sup>16</sup> Congressmen decided not to stick in this point in order to pass the amended legislation. However, they argued that when they vote the federal budget on a year basis, they review the estimated oil income submitted by the Executive. By so doing they indirectly have an influence on the amount of

The spirit of the so-called “fiscal reform” was also clear. Its aim was to guarantee during the next eight years that PEMEX will have enough resources for keeping its current level of oil production, or even increasing it slightly, and for doubling the production of natural gas. If so, oil exports will not decline severely (growing domestic demand will have a crunch in exports if production remains the same) and gas imports could become eventually eliminated. The reform also showed how a divided congress could eventually work out a beneficial policy outcome if competing interests are accommodated. Although for different reasons, it was in the interest of the political parties and the Executive to craft a reform despite their policy and ideological cleavages. After failing to open electricity markets to private participation in two major attempts, President Fox was keen on pushing this “fiscal reform” in order to reduce the uncertainties pending on the future evolution of PEMEX’s production. For opposition parties, mainly the PRD and the “nationalistic” branch of the PRI, the reform was badly needed in order to show that PEMEX and the state monopoly on oil and gas were not the problem in keeping pace with Mexico’s energy needs; it was rather the “confiscation” of PEMEX’s resources by the federal government that had to be stopped and reversed.

In fact, the debate about the reform of PEMEX’s fiscal regime is at the core of current cleavages featuring energy policies in the country. While President Fox and Congressional members of the PAN have argued that state monopolies do not have sufficient resources to increase capacity and production, opposition parties have rather argued that state monopolies remain efficient, but endangered by excessive transfers to the federal treasury. In fact, costs of production for PEMEX are not very high, ranging between 4 to 6 dollars per barrel depending on the source of estimation<sup>17</sup>. This amount is one fifth or less of the cost of producing synthetic oil from tar sands. If companies operating in the non-conventional sector of oil production manage to get a return on their investments, PEMEX should be well positioned for operating the oil wealth with no financial constraint. In that sense, the current administration has overestimated the financial limitations of PEMEX in order to press legislators to accept PAN’s most recent proposals for opening upstream activities to foreign capital. This point has also been highlighted by former president of PEMEX Adrian Lajous, whose main criticism of the current administration has been its failure to articulate a gradual opening of the energy

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oil exports. PRD members are identified with this position. (Interview with Benito Osorio, 2006 ). However, members of the Executive branch have made explicit that oil exports are being decided by market conditions and fiscal considerations of the federal government. Thus, exports ceilings could be changed from those estimated when the budget was voted by congress (See Cámara de Diputados, 2005: 30-33).

<sup>17</sup> When Felipe Calderón was at the head of the Ministry of Energy, he stated that the cost for extracting one barrel of oil in Mexico was 4 dls. According to a World Bank study, 80% of flowing oil and probable a higher share of reserves, can be produced at a cost below \$5 a barrel (2.5 dls for operating costs and a similar amount for capital costs). (Calderón, 2004 and UNDP/World Bank, 2004:32). According to Víctor Alcerreca, current federal Deputy of the PRI, and who was at the head of PEMEX-based Mexican Petroleum Institute, 6 dls is the cost of producing one barrel of oil, including all the needed investments. (Interview with Alcerreca, 2006 ). When passing the “fiscal reform” for PEMEX, Mexican legislators enacted that during the following four years, costs of production including investment will be deducted from PEMEX income at a flat rate of 6.50 dls. per barrel.

sector to private investment that takes into account Mexico's national interests (Lajous, 2006).

The reduction of transfers is somehow not a panacea for resolving PEMEX's problems. The company remains overstaffed, opaque, unaccountable, or biased administered by political stakeholders, with a record of corruption, and severely limited to make any strategic alliance in domestic markets. The so-called "fiscal reform" of December 2005 is just the beginning of other major reforms that Mexico's energy sector must accomplish if the country is really committed to modernize the energy industry.

There are still several proposals coming from Congressmen of various political parties still pending discussion in either House of Congress. Most probably, the current Legislature will not have the time to hold a final vote on them. However, some of these proposals could be recast by a new Legislature under the new presidential administration which is anticipated to start on December 1<sup>st</sup> 2006 (pending the outcome of legal challenges).

Most of the proposals pending review in Congress deal with a thorough administrative reform of Mexico's energy industry. The three major political parties (PAN, PRD, and PRI) coincide in this point, although not in its scope. PRD has presented the most ambitious proposal thus far. Legislators of this party claim that the overall energy sector must be regulated through planned state policies gearing to the vertical and horizontal integration of different sectors and branches, that is, between PEMEX and CFE activities. Prices do not have to reflect "opportunity costs" of competing fuels in the international market but must be estimated domestically, according to costs of production and targeted "rent" the government is interested in maintaining (PRD, 2002a, and interview with Diaz, 2006). According to legislators of this party, Congress must be involved in the selection of the board members of both PEMEX and CFE, and their respective directors should be responsible before Congress and not to the Executive. This would be the way to ensure the autonomy and independence of the energy sector (PRD, 2002b).

Although the three main parties concede that independent members must participate in PEMEX's governing board, the number of participants and their responsibilities are not yet clear. PRD legislators suggest the addition of three "citizen-members" to the current composition of the board, while PAN legislators argue that representatives from PEMEX's union should be reduced and the number of board members increased to 15, of which eight should represent civil society experts (interview with Ovalle, 2006).

PRD legislators suggest as well that one third of oil export surplus should be destined to finance PEMEX and CFE future investments. To this end, they have submitted a bill aiming at fostering the independence of the so-called Oil Stabilization Fund (*supra*) (PRD, 2002b). They also highlight the need to curb current gas consumption trends in power generation. They consequently prompt both PEMEX and CFE to go into co-generation and are exploring the possibility of switching to more nuclear power for boosting the supply of electricity (interview with Carrillo, 2006).

#### *4. The presidential candidates and their energy outlook*

Fox's plea for opening exploration and production activities in the gas sector to private companies and the fiscal reform finally passed by Congress framed in many ways the current debate of so-called "energy reform" to which the three presidential candidates referred to in their respective campaigns. The two poles of the debate are represented by Felipe Calderón, the winning candidate (PAN), and Andrés Manuel (PRD). Calderón's proposals pretend to continue and deepen Fox's failed reforms in the electricity, gas and oil sectors. When he was at the head of the Ministry of Energy (2003-2004), he defended Fox's initiative for privatizing electricity markets before the Senate, whose main opponents were members of the PRI. From then on, the rationale of Calderón's position is to abate domestic energy prices as a condition for redressing the competitiveness of the Mexican economy. According to Calderón's estimates the cost of generating power from CFE is twice more compared to the costs for independent producers. If private producers are allowed to enlarge their market shares along the lines of the proposal already submitted by President Fox to Congress, domestic prices of electricity will go down. This would also be true for gasoline, whose prices could also be reduced if private investors are let to participate, jointly with PEMEX, in downstream activities.

Calderón and his team also argue that technological skills for exploiting Mexico's potential reserves located in the Gulf of Mexico cannot be obtained in arms-length markets, so they suggest that the only way to develop new reserves for sustaining current production levels, is to craft "strategic associations" between PEMEX and private oil companies, a measure which most probably will need a constitutional reform. Gas imports are anticipated to continue growing, so they will be supplied by the US and by growing imports of LNG. Since imports from the US are expensive, impacting domestic prices of both gas and electricity, Felipe Calderón prefers to increase imports from overseas via LNG shipments, as a means to reduce domestic prices. He has also introduced in the debate a new legal designation for gas, for "self use" purposes. This will allow private industries to produce natural gas as a feedstock for final products, such as electricity or petrochemical products. A fiscal reform geared to further increase the resources of PEMEX is also combined with changes in the governance of the state enterprise in order to make it more accountable, transparent and less overstaffed. (Calderón, 2005 and interview with Cordero, 2006). Although Calderón and his team recognize the importance of SPP in linking US-Mexican interests, there has been no public mention so far about the future of Mexican oil exports.

By contrast, López Obrador's presidential proposal gears towards assuring energy self-sufficiency. His main goal is to maintain current oil production levels while decreasing imports of gas and gasoline. For achieving this a fiscal reform is announced for increasing PEMEX's resources; oil production will be enhanced from known reservoirs and shallow waters (but not from deep-water fields located in the Gulf of Mexico); three refineries will be built in order to increase the domestic production of gasoline; gas from the Burgos Basin will also be enhanced although most probable following a mechanism other than the MSCs. In order to

reduce gas imports, a major change would aim to revert the use of gas as an electricity input to being substituted by fuel oil and residual oil. Since Mexico's refinery output favors the elaboration of fuel oil, as most of crude processed is heavy oil, López Obrador's plans to increase its use as an electricity input and release gas for industrial use make sense. If done, this will become a major departure from past policies in which the use of gas in power generation was preferred because it was considered a clean fuel<sup>18</sup> (See López, 2005). Since self sufficiency is a "national security" goal for López Obrador and the PRD, oil exports will probably be reduced in order to supply domestic markets if production ceilings are maintained.

As for Roberto Madrazo's energy proposals, the candidate of the PRI, they are a sort of compromise between the two poles, reflecting the fact that within this party, there are strong bosses that share the points of view of the PAN, and other ones that, by contrast, support the energy policy options of the PRD. Madrazo calls for a critical revision of current oil and gas production levels in order to keep pace with domestic demand growth (See Madrazo, 2005).

Despite of the differences amongst the candidate proposals, it is clear that there is a common ground in all of them: they recognize that the status quo is unsustainable, and that Mexico's oil output must be sustained; hence investments must be increased, and state-owned enterprises in the oil and electricity sectors won't be privatized. This common ground is fully compatible with current US perceptions and interests in terms of its continental energy security concerns detailed in the first part of this essay. In other words, regardless which candidate eventually is declared the victor of the 2006 election, all of them are committed to increase investments in the energy sector in order to sustain and/or increase current oil, gas and electricity production.

However, the differences in how the PAN and PRD plan to modify the investment regime in the sector remain important in the continental evolution of energy markets. The focus of PAN on widening the scope of private participation in the production of electricity, and in upstream oil and gas, will mean that NAFTA treatment will be extended to those activities. That is, investors, investments and the services they provide will be fully covered by NAFTA obligations on government procurement, services, property rights and investments, and any legal controversy could be solved under the general or the ad hoc alternative dispute resolution mechanisms of the agreement (Núñez, 2004). The extension of NAFTA treatment to these activities will definitely increase the legal protection and certainty for foreign investors, i.e. Canadian and American firms, to participate in the future development of Mexico's energy sector. That is why I presume that such a strategy will be optimal for both US and Canadian interests, since these two countries have a strong private energy sector which would benefit from a further opening of the Mexican industry to private capital.

However, if Mexico decides to extend NAFTA treatment in upstream oil and gas, the government must be successful for pushing a constitutional reform, a major failure of the Fox administration. Chapter 6 of NAFTA is very clear in saying

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<sup>18</sup> This proposal has been strongly dismissed by Adrian Lajous, president of PEMEX during the Zedillo administration (1994-2000). See Baker, 2005.

that in case of a conflict of interpretation between that chapter and the Mexican Constitution, the Constitutional text shall prevail in the controversy. And in order to make a constitutional amendment, two thirds of the votes of Congress are required, as well as two thirds of each state legislature. When the PRI was the hegemonic, authoritarian party ruling the country, constitutional reforms were not exactly a problem. But when the ruling party does not have a majority in Congress, as has been the case since 1997, and as it will likely be in the next presidential period, constitutional reform becomes a real challenge for the President.

This is in fact the advantage of the proposal of PRD. They clearly refuse to extend NAFTA treatment to other activities already opened by the agreement, so they don't need to use their political capital for promoting a constitutional reform. What is not clear in the platform of this party is how the government is going to balance the need to keep, or increase, social spending, and maintain macroeconomic equilibrium, with a fiscal reform that will reduce transfers from PEMEX to the government. So far, proposals aimed at the creation of an energy fund for supporting both energy requirements and development infrastructure, assume an increase of oil production combined with the entrance of private capital. However, the PRD has remained silent so far on any potential increase in Mexico's oil production and seems rather to remain reluctant to foreign capital participation. We shouldn't neglect, however, that these platforms were designed for a presidential campaign. Once in power, parties could become more pragmatic when deciding their policies for the energy sector.

Finally, the current domestic debate, commanded either by presidential candidates or by public opinion, do not raise the point of infrastructure protection in anticipation of a terrorist attack. Terrorism seems to remain low in Mexican security concerns in public debates, since other priorities are about the security agenda of the country, including the increase of oil reserves or self-reliance on domestic energy production. This shows how in terms of energy security, there is no shared assessment of security threats between the two countries.

#### *6. Energy issues perceived by public opinion and experts*

Outside the political debate commanded by political parties and institutions, two major issues have dominated the discussions of experts and public opinion. The first one is, of course, the eventual privatization of energy markets in Mexico. The second is the evolution of Mexican oil exports, a point that had not been addressed by the presidential candidates.

Regarding the first issue, Mexico's population is split regarding its perception of the benefits or costs of an enhanced integration to global markets and politics. In a major poll commissioned by two leading institutions in the country, 34 percent of interviewees believe that globalization has had a rather positive impact on the country. In contrast, 31% believe this is not the case and 17% believe that globalization has affected Mexico neither for the better nor for the worse (CIDE and COMEXI, 2004:31). This split in opinion is also present across regions in the country and across population demographics. Forty-three percent of the population living in the northern states, that is, those bordering the US and consequently more

exposed to the impact of bilateral relations, consider the impact of globalization positive, as compared with only 31% of people living in the south and southeast regions. Additionally, 87% of people to be considered in leadership positions perceive as positive the impact of globalization, demonstrating the gap that exists between Mexican elites and the general population in perceptions of global trends<sup>19</sup>. In sum, while Mexican elites perceive as favorable Mexico's involvement in global trends, a significant part of the general population still has doubts, mainly among people living in the central and southern part of the countries.

This divide is also reproduced, *grosso modo*, in opinions considering the participation of private capital in the energy sector. Although 54% of Mexicans, according to the same survey, believes that foreign direct investment is beneficial for the country, only 34% believe this is the case for the energy sector, and just 27% considers it beneficial in oil production and distribution. In other words, the majority of Mexicans still perceive as negative the participation of private capital in the energy sector. This perception is again stronger in central and southern states than northern ones. This perception is not shared by Mexicans in leadership positions: 85% of them consider the participation of private capital in the energy sector beneficial, and 76% consider it beneficial in the oil sector (CIDE and COMEXI, 2004:33).

This sample shows how the political platform of the PAN, regarding private participation in the energy sector, better reflects the perceptions and interests of Mexican elites than those backing the PRD. The position of the latter party is more consistent with the generalized perception of the role played by foreign investors in the economy. Nationalist position still perceives as depredatory the interests of private capital in the energy sector. As a letter sent to a leading journal in Mexico City vividly stated, if foreign participation is opened to foreigners in the oil and electricity sectors, "...tomorrow they will ask for (Mexico's) air and water" (Reforma, March 20, 2006). This generalized perception clearly explains why nobody at the top dares to think that privatization of PEMEX is desirable or possible. Even Carlos Slim, a prominent Mexican entrepreneur who is advocating Mexico's reforms and abatement of corruption, has recently stated that PEMEX must remain a state-owned company (Reforma, February 15, 2006).

However, Fox's and PAN's proposals for enlarging the participation of private capital in Mexico's energy industry has eliminated the silence and taboo that PRI's ruling imposed on the subject for many decades. Public officials, politicians and public opinion are more and more asked to have a stake in the issue, only to realize that there are larger fractions of Mexican elites that favor a sort of accommodation with private capital. Even before the election results were available, it was clear that this issue would become a major point of discussion within the political class and/or within a divided Congress and political opposition.

As for the evolution of oil exports in the years to come, the public debate seems to remain split between those advocating for a significant increase of oil exports, and those suggesting a more prudent approach. Jorge Castañeda, Minister

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<sup>19</sup> The sample of elites was conformed by 82 interviewees (out of 176 people selected) with a university degree or higher working in government, Congress, political parties, business leaders, scholars and academics, people working on media.(Cide and Comexi, 2004:48).

of Foreign Affairs during the first two years of the Fox administration, became the first one to suggest (once he quit his position and became an independent runner for the presidential elections) that Mexico should double its oil exports in order to reap the economic and geopolitical benefits of becoming a strategic and reliable partner of the US. During his time as Minister of Foreign Affairs, Castañeda was successful in including energy flow issues along with migration and development issues in the bilateral agenda with the US. When international prices started to escalate, and after the terrorist attacks of September 11, it was evident to him that oil became again a strategic commodity from which Mexico could yield more than just market benefits. Oil was put in the bilateral agenda in order to make Mexico a reliable and safe supplier, along with Canada, to the US, in a juncture where even Saudi Arabia had ceased to play that role (Interview with Castañeda, 2006).

Once he became an independent candidate for the presidency, Castañeda better articulated his position, and proposed that Mexico should create a North American Energy Fund (NAEF), backed with US securities and investment funds, from which PEMEX could get the money for funding the doubling of its exports. Growing Mexican exports in a period of escalating prices will pay the returns of the NAEF, and will create the possibility of a parallel fund, a so-called Mexican Development Fund (MDF), from which infrastructure and development projects will be supported in order to multiply the benefits of a new oil bonanza. This formula of trading oil exports for development projects had the advantage, according to Castañeda, that no constitutional amendment was needed in order to make it feasible (Interview with Castañeda, 2006). Although no political party has officially commented on this proposal, an independent Mexican think tank has articulated the technicalities of this plan and presented it in Mexican and American forums (See Rozental and Smith, 2005 and Alberro, 2005).

At the other extreme, former director of PEMEX Adrian Lajous has claimed that Mexico should be cautious in dealing with oil exports and markets. He agrees that supplying the domestic market has become a priority security concern for Mexico, so PEMEX should give preference to domestic needs rather than increasing exports. Criticizing the Fox administration for its inability to articulate a consistent and gradual opening of the energy sector, and Lopez Obrador's energy platform, Lajous warns of mounting pressures coming from the US for a rapid opening of its oil and gas industries to foreign participation (Lajous, 2006).

### *Conclusions*

Mexico's oil wealth has traditionally increased the bargaining capabilities of the Mexican government when dealing with the United States, especially in times when the natural resource becomes strategic. Historians have argued that the expropriation of the oil industry in 1938 was politically acceptable by the US because Washington was not interested in alienating its southern neighbor during difficult times, when the possibilities of a war in Europe were escalating. Forty years later, when two oil shocks had made energy security a major foreign policy goal of the US, Mexicans established export quotas to the US and became a major

player in world oil markets. Still, during the NAFTA negotiations, oil was kept off of the agenda in order to give domestic legitimacy to the agreement.

At the turn of the 21<sup>st</sup> century, energy security has again become a buzzword in US foreign policy; but this time Mexicans do not seem to extract any leverage from the situation. There are both international and domestic reasons for this. On the international side, the major difference from the past is the emerging role of Canada as the powerhouse of North America. Growing exports of bitumen and synthetic oil will be able to compensate for an eventual decline in Mexican exports, and Venezuelan shipments as well. Canadian heavy blends directly compete with crude coming from those countries. As long as prices remain competitively high, producers from Alberta will have incentives for boosting their production. Americans have also become less vulnerable to high oil prices, at least as was perceived in the past. With prices ranging from the low to top forties, the American economy is estimated to keep growing in the long term. And last but not least, federal policies in the US are currently anticipating a scenario of “expensive oil”, in order to diversify the energy mix, stimulate technological change, and to develop sources of unconventional oil, gas and fuels. For Washington, high oil prices will also stimulate additional production from “out of risk” areas, all of which will contribute to satisfy increasing world oil demand.

By contrast, on the domestic front, Mexico’s addiction to oil income has become a major flaw for the sound evolution of its energy industry. Mexico’s historical inability to craft major fiscal reform has made PEMEX’s exports the major source of income for the government. The oil rent, whose value fluctuates according to the oscillations of world markets, has become a strategic tool out of which the government estimates the servicing of a foreign debt, social spending, and macroeconomic policies for continuing to run on deficits. By contrast, this very addiction to oil revenues has persistently confiscated valuable financial resources from the state oil monopoly, making it difficult for PEMEX to maintain a credible stock of reserves, its current oil production and to increase gas production for decreasing imports. If there is any security concern in Washington in relation to Mexican oil wealth, it is precisely the uncertainties regarding the future of its production.

Two major options loom in the horizon of Mexican oil politics. The first one is clearly delineated by the Fox administration and Felipe Calderón. According to this strategy, NAFTA treatment should be extended in the energy sector, to let private companies participate in upstream oil, gas and electricity activities. This proposal will in fact continue the pattern of institutional change Mexico has pursued since the mid-eighties, when Mexico’s unilateral economic opening by joining GATT accelerated and locked in market-oriented reforms in the country. NAFTA became a watershed in Mexico’s economic organization, since privatization and a new disciplinary body regulating state-firms relations ended up with state dirigisme in the economy, a model that went into crisis after the early eighties. Although an assessment of market reforms in the country is beyond the scope of this essay, it must be highlighted that they are at the backbone of major state reforms witnessed by the country in the past twenty years, through which government policies have become more predictable and more accessible to multiple stakeholders.

If the PAN government sticks to its commitment of not privatizing PEMEX or CFE, a further opening of the sector will in principle have a positive impact in Mexico's energy sector: the two oil monopolies will increase their capital for investment and will be forced to become more transparent, efficient and open to stakeholders than those currently running the company. Such a scenario however, requires a constitutional reform in order to make clear and transparent the scope and extent of private participation in the energy sector. Such a reform would require a lot of political capital with unclear additional benefits. A PAN government should be careful to spare part of that capital in order to push, as well, a change in the fiscal regime of PEMEX and CFE in order to let them become attractive to investors or potential competitors.

The second option was supported by the PRD and its presidential candidate, Manuel López Obrador. Under the PRD formula, Mexico's addiction to oil income would have probably been maintained, if not increased. The government would have capitalized on a huge oil rent for running public programs and increasing its constituency on regions where the PRD was still weak. Although Mexico would have exported most of its petroleum to the US, the eventual decline in production could have become a political playing card on the bilateral front, although with limited strength. No constitutional reform was needed, and eventually, no change in PEMEX's fiscal regime. The major uncertainties of such a scenario were the mid to long term consequences for Mexico's energy sector in terms of its own modernization and its ability to adapt to changing world oil prices.

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