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The purpose of my remarks today is to examine the basis for Mexico’s recent energy reforms, to assess the major threats to its effective implementation and success, and to identify policy challenges that, if addressed, can strengthen the United States’ relationship with Mexico.

**Energy Reform Was Not a Choice**

Mexico’s leaders did not deliberately choose to enact energy reforms. Rather, it was a policy shift forced by circumstances. Mexico has seen its oil production drop from about 3.5 million barrels per day (b/d) in 2008 to about 2.3 million b/d in 2015. At the same time, the country’s energy consumption continues to grow. At current rates of production and consumption, Mexico will become a net importer of oil somewhere around 2020.<sup>1</sup> Complicating matters, the country’s federal budget is heavily dependent on oil revenues—about 30% to 35% of the federal budget comes from oil revenues.<sup>2</sup> Because Mexico’s national oil company, PEMEX, handed over so much of its profits to the government, it could not reinvest in additional exploration and extraction of oil and gas, or in technology to tap into new sources of energy located in deep waters off the Gulf of Mexico. A no-change scenario would have put Mexico in a very difficult situation within a few years: it would have to spend valuable national resources to import oil and slash its federal budget by nearly one-third.

Thus, Mexico’s energy reform, in my view, was primarily motivated by revenue maintenance and generation concerns, rather than a conviction that the free market would improve the country’s energy future and advance economic development. Many of the contours of the reform

demonstrate this intent. For example, the Mexican government, while reforming some aspects of PEMEX, continues to maintain tight control on the company. In the March 2015 Round Zero oil auction, PEMEX was the only bidder and received over 80% of the oil and gas plays it wished to keep.<sup>3</sup> What PEMEX did not want or could not keep was then fair game for others in subsequent bidding rounds. Second, the terms and conditions of contracts offered to foreign and private investors originally capped revenues, ensuring maximum revenue flows to Mexico's federal government. Companies pushed back. Since some of these caps on profits have been flexibilized. Third, the government has legislated that any contract can be rescinded at any point, even due to purely administrative violations—an undefined term, which will give federal bureaucrats enormous discretionary power over continuing, modifying or ending contracts. Fourth, the government intended to prohibit contract clauses that allow investors to bring contract disputes to international arbitration bodies, preferring to instead resolve disputes in Mexico's courts—which are notoriously deficient and susceptible to corruption. The courts' ability to fairly consider the interests of both investors and the Mexican government is questionable, to say the least. It is not clear yet whether Mexico's government has backed down on this point.

These examples are among many indicating that Mexico's government would have preferred to keep tight control of the energy sector rather than open it to foreign investors. However, circumstances forced the government to opt for reform. The reform, therefore, is a managed opening of the sector, rather than a full market-driven reform. It is likely that Mexico's government will try to maintain the upper hand in the energy sector, rather than allow market forces to determine production, consumption and profits. In my estimation, Mexico's energy reform is more restrictive than that of other countries, and continues to give the government excessive power over the sector. This should be kept closely in mind as Mexico's open energy market becomes an integral part of the North American energy landscape.

The results of Round One, Mexico's oil and gas play bidding process that took place July 15, 2015, were disappointing. Only two out of 14 blocks were sold. This is partly because the geopolitical market conditions of supply and demand are unfavorable to Mexico at this point; but it is also because there is much trepidation in the industry as to how to respond to the Mexican government's intent to retain the upper hand in the sector. This has introduced much uncertainty into the bidding process, and many industry actors have adopted a wait-and-see attitude.

Still, the situation in Mexico is not uncommon. Most countries heavily manage their energy sector, and IOCs have a long history of dealing with governments, even in difficult situations. Even so, Mexico presents unique challenges that must be examined closely. Although the country is not completely unpredictable, its institutions are not always accountable. As I attempt to break down these challenges, I will argue that, insofar as the U.S. is concerned, a much more comprehensive and forceful foreign policy toward our neighbor is required.

## **Major Threats to Energy Reform**

Threats to energy reform in Mexico come from within the country itself. Its unique historical and structural problems might yet derail some of the positive effects of the historic reforms. In my view, three major problems threaten the success of energy reform implementation, and they must be considered as the U.S. examines its foreign policy toward Mexico: 1) Weakness of the rule of law and security issues; 2) Property rights, natural resources and social conflict; and 3) Corruption.

### *Weakness of the Rule of Law in Mexico and Security*

The weakness of the rule of law in Mexico is historical and structural. These weaknesses must be understood in the context of the country's presidential system. During much of Mexico's existence, presidents have been more akin to strongmen than democratic rulers. During the 21st century, Mexico's president was the central figure in the country's government and governance processes. The president dominated all of Mexico's institutions, including the central political party, Congress, state and local governments and the judiciary. The weakness and strength of Mexico's institutions were carefully calibrated to ensure that no one would challenge the central ruler during his six-year term, and that the powerful PRI party would stay in office. In 2000, when Mexico made the leap to a more democratic transition by voting into office an opposition party, most institutions were able to reconstitute themselves; they function relatively well and independently of the weakened executive branch, except the judiciary. The police and judiciary systems in Mexico remain structurally weak. They are ineffective, underfunded and highly susceptible to corruption.

The weakness of the civilian police-justice system in Mexico has emboldened organized crime in the country. The last 10 years have seen an upsurge in criminal violence that has spread to vast swaths of the Mexican territory. Criminals, as we have seen with the recent escape of Joaquín "El Chapo" Guzmán Loera, feel they can corrupt nearly any official and strike at the State almost anywhere at will.

U.S.-Mexico agreements, such as the Mérida Initiative, which have focused primarily on drug trafficking, have done little to overcome the structural weaknesses of the civilian police and justice systems in Mexico. Instead, the effect has been to break up Mexico's organized crime organizations into dozens of smaller, powerful groups that control cities and corridors and that have diversified their criminal activities to include kidnapping for ransom, extortion, human smuggling and trafficking and, of course oil, gas and fuel theft.

This is, in fact, one of the greatest sources of concern for foreign and private investors seeking to enter Mexico's newly opened energy sector: they fear their investments, workforces, equipment and products may eventually be tapped into by organized crime. There is much unease with this situation, and it may have contributed to some companies taking their time to examine Mexico more carefully before going into business there.

In hindsight, U.S. efforts to prod Mexico into fighting hierarchical criminal organizations have also contributed to the fragmentation of these organizations into dozens of smaller criminal gangs and to the diversification of their criminal activities. Such a result can be viewed as a way to eventually send the military back to the barracks and allow local police forces to face down the smaller gangs of criminals. However, this has not happened. The local police forces, some 400,000 officers in the country, are underpaid, underequipped, unprepared, probably undervalued and generally incapable of confronting the well-organized, disciplined and well-armed gangs that dominate cities, towns and corridors throughout the country. This situation makes the police particularly susceptible to corruption. The problem of criminal groups in Mexico is, as a consequence, much more difficult to control.

### *Property Rights, Natural Resources and Social Conflict*

In Mexico, individuals own the use of the land, but do not own the rights to the water or oil beneath it. Two major issues may emerge out of this. One is the fact that foreign companies will have to negotiate with landowners to access natural resources. Considering that 51% of Mexico's land ownership is social—either in the form of *ejidos*<sup>4</sup> or as indigenous lands—this can also mean that many companies will be forced to negotiate not with individual owners, but with entire farmers' groups or indigenous groups over issues such as right-of-way, water availability, use of the land, reparation and remediation. This is a potentially explosive situation that may give rise to social conflict, particularly as landowners resist granting a right-of-way or permanently or temporarily ceding their land for energy projects, as the law mandates. Worse, the law gives landowners 180 days to agree to grant access to minerals under their land, or the State will force them to accept a third-party negotiator. This can be a recipe for social conflict.

There seems to be another conflict in Mexican law that needs further investigation. Whereas energy reform gives energy-related projects priority over the use of natural resources under the theory that it is in the interest of national development, the water law in Mexico states that access to water is a human right and human access to water is a priority over other uses. This is not likely to affect the large oil corporations—many of which will invest in deep waters in the Gulf of Mexico in any event—but it may become relevant once oil and gas prices recover and the shale in northern Mexico, where water is extremely scarce, begins to be developed. In this regard, it is possible that social conflicts over water resources may develop in the future, particularly in northern Mexico, right across the Texas border.

### *Corruption*

So far, the Mexican National Hydrocarbon Commission and other energy authorities in Mexico have done an excellent job of maintaining the process of opening the energy sector in a way that is both transparent and responsive to the concerns of the industry. However, corruption by the political class is another concern in the implementation of energy reform. In fact, President Peña has himself been involved in several corruption scandals that have undermined the legitimacy of

the energy reform as well as of other reforms. As of yet, there is no effective anti-corruption system in Mexico capable of dealing with governors and mayors, many of whom are notoriously corrupt and will ultimately have the ability to make the life of investors in the field very easy or very difficult. Many of them will also be seeking opportunities to use their political power to maneuver themselves into deals as partners with private and foreign investors.

The failure of Round One this month cannot be attributed to a lack of effort on the part of the Mexican federal government to be clear about the terms of business and to respond to the concerns of industry. But this transparency and responsiveness cannot be guaranteed in the long term, or even in the medium term, in a system that suffers from endemic corruption, and where there are hundreds of actors at the federal, state and local level with the ability to affect energy project development throughout the country. Corruption in Mexico has become a lifestyle. Mayors, governors, members of Congress and politicians of all sorts tend to view public service as a way to serve themselves as well as the Mexican people. They have embezzled public funds; used their political power to ensure privileges for themselves, their families and friends; and inappropriately used their public position to engage business interests to enrich themselves. By almost any measure, Mexico ranks among the most corrupt countries in the world.<sup>5</sup> This is one of the most important concerns of the energy industry—that they may be liable under U.S. law for corrupt practices in Mexico. Their concern is justified, as they will eventually have to deal with hundreds of politicians at all levels. Although the energy sector is under federal jurisdiction, the energy projects themselves have a fundamentally local character. They take place in communities across the country under the eye of citizens and politicians everywhere.

This does not mean that the U.S. should let up on enforcing its foreign corrupt practices laws, but rather, that it should become more attuned to the challenges that the industry will face in a country where corruption is wide and tolerated.

## **Conclusions**

To conclude, it is important to note that the failure of Round One this month is an inauspicious sign. Energy reform will move forward, but it will experience more difficulties than expected. The structure of incentives built into contracts, the natural resource conditions, property rights, and the weak rule of law all threaten the smooth implementation of energy reform in Mexico.

Without a comprehensive foreign policy toward Mexico in the energy arena, there is very little the United States will be able to do to help this situation. Until now, Mexico has been dealt with very tentatively, given the country's nationalistic sensibilities. The Peña administration in particular is even more sensitive to American activities in Mexico than the two previous PAN administrations were. But there is hardly any country that has more leverage on Mexico than the United States. Thus, the U.S. government should now reexamine its relationship with Mexico and begin to put together a policy that goes beyond trade, economics and the drug war. Mexico and the U.S. must now engage in policies that emphasize institutional development, democracy-

building measures and an intense campaign to fight corruption, as well as binational human and labor mobility and the creation of binational institutions that work for both nations. Below I outline some basic policy recommendations.

### **Policy Recommendations**

- 1) *The Mérida Initiative should be replaced with a more comprehensive policy toward Mexico.*

The Mérida Initiative has not paid off. Although there are some isolated victories, it is now clear that the Mérida Initiative has not had its intended effects. While it has helped break up most of the large criminal organizations that existed in Mexico, it has created a more fragmented and chaotic criminal landscape. There are now anywhere between 60 and 80 criminal organizations, some dedicated to drug trafficking, notably the Sinaloa Cartel, but dozens of them are now dedicated to victimizing Mexican citizens through kidnapping, extortion, robberies and theft. Some of these organizations have special units dedicated to oil, gas and fuel theft. We have also seen some unscrupulous U.S. business owners buy some of that ill-gotten oil from Mexican criminals, notably in Texas. Energy investors, and particularly those that will invest on onshore projects, will necessarily confront some of these organizations. Their equipment, their personnel, and in general their investment will come under fire here and there.

- 2) *Focus American foreign policy on strengthening Mexico's institutions, particularly the police and judicial systems.*

Mexico's government has made very little progress in implementing the 2008 Judicial Reform.<sup>6</sup> Although some states have made substantial progress, most of them lag well behind, so the Judicial Reform will likely not be implemented by 2016, as mandated by the law. The United States must now urge Mexico not only to implement Judicial Reform but also to implement a more forceful anti-corruption program that primarily focuses on making the judiciary a truly independent branch of government, with the capability, the resources and the political will to investigate and punish corruption wherever it may be found. Without a strong and independent judiciary capable of investigating political and other corruption, Mexico will not be a reliable partner in achieving a North American energy plan or a broader North American economic bloc.

- 3) *Aggressively include Mexico's political class in corruption investigations.*

The United States is the destination of many in Mexico's corrupt political class. They freely move about in the United States; they do business in the United States; they launder their ill-gotten profits in the United States; they send their children to the United States; and they generally use the United States to seek refuge when they face complications in Mexico. Policy toward Mexico must now include a serious effort to

address corruption in Mexico by investigating the country's political class and targeting them with anti-corruption efforts. There should be no access to the United States to anyone accused of malfeasance in Mexico.

- 4) The U.S. must develop a more comprehensive policy toward Mexico, one that considers labor integration, manufacturing chains, energy swaps in oil and gas, and financial sector integration, along with additional funding targeted to the promotion of institutional reform in Mexico's police and judicial system. Trade between the two countries is a story of success, but we have not been able to use this success to ensure that its dividends quickly spread to other areas, and we have not used that momentum to create truly regional institutions that will help us achieve a fully developed and democratic North America, one that will work for all Mexicans and Americans. Mexico's energy opening is yet another important step, which we must take advantage of to make a final push to create the most prosperous region in the world.

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<sup>1</sup> Kenneth B. Medlock III and Donald Soligo, "The Future of Oil in Mexico: Scenario for Oil Supply, Demand and Net Exports for Mexico," James A. Baker III Institute for Public Policy at Rice University, Houston, Texas, April 29, 2015.

<sup>2</sup> Mexican Republic Decree on the Federal Budget for FY2015. November 13, 2014,

[http://www.hacienda.gob.mx/INGRESOS/Ingresos\\_ley/2015/lif\\_2015.pdf](http://www.hacienda.gob.mx/INGRESOS/Ingresos_ley/2015/lif_2015.pdf).

<sup>3</sup> See Secretaría de Energía, "Results of Technical Analysis," found at

[http://www.energia.gob.mx/webSener/rondacero\\_Ingles/9600.html](http://www.energia.gob.mx/webSener/rondacero_Ingles/9600.html).

<sup>4</sup> *Ejid*os are communally owned lands, assigned by the government to farmers and ranchers to manage collectively during the agrarian reform laws of the 20th century. Although legislation in the early 1990s allowed many to sell their land, numerous *ejidos* are still operational.

<sup>5</sup> Mexico is ranked 103/175 by Transparency International, with a score of 35/100. There is little enforcement of anti-corruption laws. See <http://www.transparency.org/country#MEX>.

<sup>6</sup> Trans-Border Institute. Joan B. Kroc School of Peace Studies. University of San Diego. *Judicial Reform in Mexico: Change and Challenges in the Justice Sector*. 2010.