



**PURSUING NORTH AMERICAN ENERGY INDEPENDENCE:
MEXICO'S ENERGY REFORMS**

HEARING BEFORE THE U.S. HOUSE OF REPRESENTATIVES
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*** As Prepared for Delivery ***

Good afternoon, Mr. Chairman, Mr. Ranking Member, and Members. It is a privilege to appear before you again. I am pleased to offer testimony on North American energy independence and the importance of Mexico's ongoing reform efforts. Thank you for the opportunity to join this timely and important hearing.

As I suggested during oversight testimony in February before this Subcommittee, our most immediate neighbors have the greatest impact on our strategic interests. It is significant and consequential that we have a northern neighbor, Canada, which is both our top trade partner and top energy supplier, and which is stalwart in working with us to address the toughest global issues. Our southern neighbor, Mexico, is our second largest export market and also third largest energy supplier. Together, the three nations of North America are quickly becoming a fully integrated production platform, with tightly-knit supply chains and ever-deepening commercial ties. As China and others have emerged to challenge the pre-existing global economic order, the ties that bind us within North America have created economic efficiencies, built competitiveness, and directly contributed to the economic growth that our citizens both desire and deserve.

Access to affordable, stable energy supplies has been a fundamental driver of strategic U.S. policy on a bipartisan basis at least since the 1930's. Actions that the three North American governments take to increase regional energy integration contribute meaningfully to support and expand our competitiveness in a manner consistent with U.S. interests. Mexico's decision to open its energy markets and link them more closely to its North American neighbors is therefore a historic and meaningful action for Mexico itself as well as a strategically important step for the entire community of North America.

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Mexico's Energy Reforms are Transformational

It would be difficult to overestimate the importance of Mexico's potentially transformational energy reforms, once fully implemented. The Mexican energy sector is historically quite sensitive politically. It was closed to foreign investors for over 75 years. The sector would benefit from additional technology, management expertise, and capital to address production declines and high costs, which are a drag on competitiveness and economic performance.

Since 2013, the Peña Nieto administration has been working to address this, passing and now beginning to implement legislation allowing for private participation in both the oil and gas and also power generation sectors. At the same time, the government has expressed awareness of the need for full transparency in the reform and bidding process in order to build broad public faith that the final outcome will be fair and free from corruption and sweetheart dealing. This is a critical point, upon which the sustainability of the entire reform effort ultimately depends.

Since the beginning of the reform effort, the price of crude has fallen approximately 50 percent, which impacts investment decisions particularly in sectors as capital intensive as energy. Investors become more selective and the quality of investment opportunities becomes paramount. There have also been recent setbacks regarding the rule of law in Mexico, notably the mid-July escape from prison of Joaquín "El Chapo" Guzmán. While not directly related to the energy sector, this does play into a narrative concerning the risks of doing business in Mexico with a particular focus on corruption and the rule of law.

Taken together, these data points have led some observers to turn more bearish on Mexico's energy prospects. Some of these issues may have been in play on July 15 for Mexico's first round of investor bidding, in which only two of 14 blocks offered to investors were awarded. But I would submit that this focus misses the bigger picture.

Investment Decisions for the Longer Run

The first bidding round featured marginal shallow water blocks, with prices arbitrarily set by the government. Future auctions will feature more attractive deep water and onshore unconventional shale oil and gas blocks. Lessons learned from the first auction on pricing and other matters will also be applied to later rounds. As well, on a comparative basis globally, additional investment blocks are larger and potentially more significant than those available elsewhere in the world.

Investor interest in the deep water reservoirs of the Gulf of Mexico and unconventional shale oil and gas in the Eagle Ford shale in the Burgos Basin is high. Mexico's shale reserves are the sixth largest in the world, according to the U.S. Energy Information Administration, overlapping with shale resources in southern Texas. Just as the shale revolution increased U.S. oil production by more than 55 percent, the application of new technology, capital, and best management practices could catalyze a similar jump in oil and gas production in Mexico.

Temporary set-backs aside, Mexico's energy reform efforts are a broader play which will continue to attract interest.

Power Generation and the Environment

While most attention has been on the oil and gas sector, power generation is also being liberalized, and this may prove to be an even bigger story because the cost of electricity in Mexico is well above global rates. This raises overall production costs making Mexico less attractive in manufacturing and other activities, while also reducing disposable income available to consumers who might otherwise reallocate their spending. While previously only the Federal Electricity Commission (CFE) was allowed to generate electricity, the sector is now opening to private investors. Overall, energy infrastructure must be upgraded, including pipelines, rail, waterways, and transmission lines, among others, and CFE recently announced that it would tender projects for close to \$10 billion. As investment increases and prices go down, Mexico will become more competitive as resources are directed toward more efficient and productive uses.

Power generation reforms also directly impact broader issues, in particular the environment and global climate change. Updating infrastructure allows for more efficient power generation, utilizing cleaner and more renewable fuel inputs. Of course, conservation is the cleanest and most cost-effective fuel available, and should be actively promoted in addition to efficiencies. Beyond this, Mexico's reforms promote renewable energy development, and investors have shown a keen interest in accessing this market, especially wind, solar, and geothermal. Regulations are sound and provide a clear framework for investment so long as targets are flexible. As well, clean energy targets can contribute to overall energy targets, both on a North American and a sub-regional basis.

Mexico's Reforms Positively Impact North America

The success of Mexico's energy reforms is important for the United States and for North America broadly. The North American production platform is already integrating content produced across borders; some 40 percent of the content of goods exported to the United States from Mexico is originally U.S. content. From Canada, the figure is 25 percent. From China, it is merely four percent.

Actions which contribute to Mexican competitiveness can therefore help to increase our own economic well-being. In particular, investment restrictions to date mean that natural gas in Mexico is more expensive than in the United States, increasing production costs in sectors that use gas as a feedstock such as chemicals as well as in all sectors that draw from the power grid. This reduces manufacturing competitiveness. Gas imports from the United States have helped, although inbound pipelines are functioning at capacity. More could be constructed, but a better solution would be to develop Mexico's own energy resources, which reforms are intended to do. Substituting cleaner fuels such as gas for diesel would also support national and regional environmental targets. Once fully implemented, prices would fall and the North American manufacturing platform would become more competitive vis-à-vis global production centers such as China and Europe.

The U.S. Role

In support of Mexico's reforms, the United States has an important role to play. In the first instance, Congress could strengthen U.S.-Mexico energy relations by lifting crude oil export restrictions toward a proposed swap between Mexico and the United States, a procedure already allowed with Canada. Mexico would supply heavy crude in exchange for U.S. light sweet crude to best take advantage of refining capacity. Not only would the swap be a welcome move toward dropping the U.S. crude oil export ban, but, symbolically, would provide Mexico similar treatment as our other NAFTA partner.

More broadly, regional energy integration must be a priority not an afterthought, underlining an intentional drive for economic expansion. Within this construct, regulatory alignment is critical, infrastructure must be upgraded, investment climate issues including an emphasis on workforce development should be addressed, and joint research and development projects expeditiously pursued.

Finally, in the run up to the Paris meetings in December, a regional approach to climate change issues would be useful and should be pursued as a means to engage the global dialogue. In March, the United States and Mexico released a joint statement on climate cooperation, launching a clean energy and climate task force. In May, North America's energy ministers established a working group seeking to harmonize relevant regulations.

These are solid steps. More can be done. The key to this overall agenda is the successful implementation of Mexico's liberalizing reforms. It is manifestly in our own interests that the Mexican people succeed. We should assist the process where appropriate and wherever we can.

I look forward to your questions.