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Dirección estable: http://www.aacademica.org/000-036/74
Draft Paper

The Mexican Oil Industry Reform (2008): Improvements and Backwardness in terms of Good Governance

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Introduction

Even if our general interest consists in exploring the challenges of good governance within Latin American National Oil Companies’ (NOC’s), this paper will focus only on the case of the Mexican national oil company Pemex.

I. An overview of Pemex and the Mexican oil industry

Even though it has experienced serious fundamental problems, Petróleos Mexicanos (Pemex) is still an important National Oil Company. For the period of 2007, as an oil company, Pemex was ranked third worldwide in terms of production, and has been an extraordinary money making machine for the Government of Mexico. During the same period, only Exxon Mobil had a higher gross income.

In contrast with its productive output and economic prowess, the company is faced with an extremely critical situation. It lags behind its international contemporaries in terms of exploration; it is underfunded in the area of capital investment required to maintain and expand its productive capacity, and it lacks necessary modernizations in terms of operations and technology. These insufficiencies have their origin—in whole or in part—to the institutional and organizational framework found in both in the Mexican oil industry and Pemex.

For the above-mentioned reasons, it is logical to analyze the question of the good governance of the Mexican oil industry and the Mexican National Oil Company

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(Pemex) from an organizational and institutional perspective. In the first part of the paper, we will first briefly examine the main deficiencies of Pemex and the Mexican oil industry. We will use as a means of measure the five principles of Good Governance of NOC’s, as published by Chatham House in April 2007.

Subsequently, we will examine the Mexican Oil Reform legislation of 2008, touching on the different proposals put forth by competing political actors to change the institutional and organizational framework; and the resultant main laws and amendments as approved by the Mexican Congress on October 28th, 2008.

In a third part of the paper, we will analyze the actual achievements and limits of these reforms in regards to the Chatham House principles, and also how these changes have manifested themselves over time. And finally, we will make a brief comparison with two other Latin American NOC’s, contrasting Pemex with Petróleos de Venezuela (PDVSA) and Petróleo do Brasil (Petrobras). This comparison will illustrate the main advantages and difficulties faced by each company as it faces its own institutional and organizational issues.

As previously mentioned, we will use as our means of measure the checklist of the five principles of the “Good Governance of the NOC’s”, as put forth in the Chatham House Document. These five principles are:

1. Clarity of goals, roles and responsibility
2. Enablement to carry out the role assigned
3. Accountability of decision-making and performance
4. Transparency and accuracy of information
5. Sustainable development for the benefit of future generations

An explanation of these principles vis-à-vis Pemex follows below.

1. Clarity of goals, roles and responsibility in policy and strategy design

Pemex—the Operator—faces two main problems. The first, it that it is caught between two contradictory missions: its role as a provider of Social and National goods, and its mission as a commercial and business entity. The second problem is that there is a mismatch between itself and its subsidiaries.

In addition to the two main problems stated above, there exists a confusion of roles and objectives between the Owner, the Regulator, the Operator, and the Fiscal authority. As an example of the confusion between the Owner and the Operator, Pemex has been usurping and retaining for itself the important roles of planning and central

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3 While there is no codified model of good governance, a consensus does exist regarding certain principles designed to improve the operative flexibility, with the objective of maximizing the economic value of the resource (Chatham House document).
administration. These roles by principle should be part of the Ministry of Energy (which illustrates a lack of competence and accuracy of information within the ministry). Between the Operator and Regulator, there is tacit self-regulation within Pemex which is independent of external oversight.

In terms of the relationship between the Operator and the Fiscal Authority, there is also a mismatch. Pemex is dependent on the Ministry of Finance in regards to its crucial financial decisions, i.e., budgeting, capital expenditures, incursion of debt, issuance of bonds, etc. However the Ministry takes no responsibility for the outcomes of these decisions, leaving the consequences to be borne entirely by Pemex.

2. Enablement to carry out the assigned role

There is a reduced enablement, defined as “the mismatch between where skilled people are concentrated (in the operating companies) and where they are also needed (in the ministry, regulator or broader government)” due to lack of autonomy. The Operator and Regulators do not have sufficient means in terms of authority, financial resources, information and human resources (professional training and experience) to carry out their assigned roles.

On one side of this equation, the Operator (Pemex) suffers from a variety of problems including: a lack of budget autonomy (the ability to make decisions and execution in a timely manner); the lack of adequate laws (the legal framework governing infrastructure, purchasing and leasing); insufficient human resources (due to the influence of the Oil Trade Union); inadequate contractual relationships with employees (due to lack of flexibility, incentives, and sanctions), and politicization in the appointment of managers.

On the other side of the equation, the Regulators (SENER and CRE) have had similar problems. The Ministry of Energy (SENER) lacks accurate information and human resources, and also suffers from a high level politicization of managerial assignments (a very high turn over rate and a lack of continuity of policies). The Energy Regulatory Commission (CRE in Spanish) lacks budgetary autonomy and is deficient in regards to professional civil servants. It also depends too heavily on the Ministry of Energy (SENER).

3. Accountability of decision-making and performance

At present there is an inadequate balance between the factors that influence decision-making and performance. These factors are, an improper amount of regulation (there are too many normative laws which are a product of a highly bureaucratic system); inadequate establishment of performance measures (there is a lack of

benchmarking of Pemex’ performance); and, the absence of incentives and sanction to promote greater accountability.  

Currently, there is a lack (or seeming inadequacy) of appropriate regulation and accountability. There is no real policy or regulatory oversight of Pemex; and it lacks a regulatory body for upstream activities. Additionally, there is an inefficient oversight of the Auditoría Suprema de la Federación (ASF) (Congressional Accountability Office) which, in theory, should serve in an auditor’s capacity.

4. Transparency and accuracy of information

Even though this area has seen great improvement over time, there still remains a large information gap. This is mostly due to the dissemination of misinformation on the part of Pemex; and this lack of transparency is evident in the insufficient provision of information about:

- Pemex’ actual productive capacity and reserves;
- Transparency in licensing; and,
- “Gifts and donations” to local states (read corruption)

5. Sustainable development for the benefit of future generations

This area, which perhaps the most important and has the greatest potential long-term impact on society, has been neglected in many of its aspects. As for the management of the resource in a sustainable manner, rent seeking (the desire to exploit reserves and maximize production) has predominated over the desire to ensure energy security for future generations. For its part, concerns about the externalities of environmental impact have also been given little attention. This lack of concern manifests itself in the flaring of natural gas, the pollution of rivers, the contamination of soils and aquifers, etc. As a further indicator of lack of forethought, revenues derived from oil activities have not been managed in a way to promote sustainability. Petroleum revenues mainly have been used to cover the cost of current operations and have not been managed for investment for the future.

As an interim conclusion, in measuring the performance of Pemex and the Mexican oil industry in terms of the Five Principles of Good Governance we can conclude that both entities have been far from satisfying the Chatham House criteria. Indeed, it was this lack of overall performance within the petroleum sector that provided the impetus on the part of policy makers to implement legislative changes and provoked the large

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5. As an example of the overregulated system, we recommend to see the chart of Ramirez Lavin. AMEE Congress, 2007. [www.amee.com](http://www.amee.com)

amount of political activity that culminated in the reforms that were finally approved in 2008.

In the next section, we will present an overview of the main features of the reform that attained final approval on October 28, 2009. This information will be presented to distinguish areas of concern in order to illustrate the deficiencies of Pemex and the Mexican oil industry in terms of good governance.

II. The 2008 oil reform

Before proceeding to review the reforms as such, we will examine in a detailed way each of the proposals put forth by the three major political parties. They include the proposal presented by the President of Mexico (Lic. Felipe Calderón) on April 8, 2008 and supported by his party, the Partido Acción Nacional (PAN); the proposal of the Partido de la Revolución Institucional (PRI) submitted on July 28, 2008; and, the proposal put forth by the Frente Amplio Progresista (FAP) in late August of that year. We will begin by examining in detail the five initiatives of President Calderón contained in the three areas below. These initiatives ‘started the ball rolling’ on reform and served as the framework upon which all of the other proposals were developed.

The areas of change proposed by President Calderon´s initiatives were as follows:

1. **The administration of the oil sector** (amending the regulatory law contained in article 27 of the constitution governing the industry); **the new organic law of Pemex** (replacing the 1992 Act); and, **the creation of a special tax regime** focused on complex areas of exploration (Deep Water and Chicontepec);

2. **The administration of the energy sector** (amending the law of the Energy Regulatory Commission (CRE) (1995 Act) as well as the creation of a new regulatory entity for upstream activities (the National Petroleum Commission); and finally,

3. **The federal government** (through the proposed amendment to the 1976 Act (Article 33) to provide greater capabilities to the Ministry of Energy as well as amend the Public Works law (with the enactment of new contracts).

Judging from the reaction to these initiatives by political actors, it is interesting to note that the main points of discussion and areas of contention were focused on three main areas. They were:

- Deep and Ultra Deep Waters;
- Investments in the midstream; and,
- The concept of “incentive contracts”

At this point, we will present the contributions and differences of the plans set forth by the Partido de la Revolución Institucional (PRI) and the proposal put forth (from the left wing) by the Frente Amplio Progresista (FAP).
Without going into too much detail, it can be observed that the proposal put forth by the PRI was very similar to one by the PAN, with some significant exceptions. These exceptions were an absolute rejection of private investments in the midstream; strictures against incentive contracts to prevent them from becoming risk contracts (prohibited by the Constitution), and initiatives concerning renewable energy, climate change and energy transition.

The proposal of the FAP (left wing movement) was much more radical in nature. It introduced numerous initiatives. However, the most relevant of its tenets was the rejection of private investments in the midstream, and the denunciation of incentive contracts. It also opposed the validity of appealing to foreign laws and courts in the case of disputes involving Mexico and international parties.

The reform, which was approved on October 28 with near-unanimity, was in the end a compromise between the partisan proposals. It was the result of often-intense negotiations between the parties (sometimes forgetting the advisories issued in forums between May-July 2008). The Reform that was finally set into law was an offshoot of Calderon’s initial proposal and included the areas of common agreement between all political parties. It was careful to eliminate the greatest point of contention between the three major political forces. As previously mentioned these areas were private investments in the midstream, and the question of the jurisdiction of foreign courts.

In the next section, we will evaluate the contributions and shortcomings of this reform proposal (in conjunction with the five Chatham House principles) in order to describe the modalities of its implementation in the year 2009.

III. An initial evaluation of the oil reform

A. Advantages and deficiencies of the new reform

While being less than what many had hoped for, the Oil Reform has offered some benefits. First and foremost it has been the product of an historical agreement between the three major political forces. It also captured some of the ‘best practices’ in terms of good governance in the industry, and its new special tax regime will stimulate activities in difficult areas. Nevertheless, the ‘down-sides’ are numerous. The monopoly of the State remains untouched; and it is not clear that the legislation will actually help overcome the crucial challenges faced by the sector, namely the decline in reserves, diminishing contracts, lack of refinery capacity, etc.

It can be asserted that the greatest achievement of this reform was that it provide all parties with a political victory; and in the end all actors emerged triumphant (at least at the moment of its approval). Felipe Calderón and his party compromised to a “watered down” version that offered them some political success. The PRD was able to
improve its image away from being considered a party of intransigence and was able to insert some of its ideas into the final legislation. For its part, the Union of Oil Workers of the Mexican Republic (STPRM) was able to preserve its prerogatives in a comprehensive manner (e.g. preservation of its monopoly over the gasoline transportation corporation). But undoubtedly, the big winner in the process was the PRI, as its proposals constituted the main body of the reform.

Despite the spirit of reform that was embodied in the text of the initiatives unveiled by President Calderón in April 2008, it is not clear that the resulting reforms would actually promote the major changes desired to the management of the sector. It was also not clear whether the reforms could favorably influence the amelioration of the Pemex’ persistent problems: the decline in production and the obsolescence of the midstream segments (refining, transportation, etc.).

In light of the Oil Reform, the issue that arises is: How to evaluate the text of the Reform in regard to the Chatham House Principles of Good Governance? The following section examines the reforms as they relate to those Five Principles.

B. The reform with reference to the principles of good governance

1. Clarity of goals, roles, responsibilities

It appears as though principle of “clarity of goals, roles and responsibilities” has not been truly attained in concrete terms. For example, the increase in the number of committees provided for by the legislation (e.g: ASF, SFP, OCI of Pemex) might have the opposite-than-desired affect. Indeed, an increase in committees may be a source of more confusion in terms of roles and responsibilities. For instance, what might be the specific role of the Accountability and Transparency Committee vis-à-vis the Board? And what might be its peculiar portfolio of responsibilities in regards to other entities such as the Federation Supreme Audit (ASF), the extinct Public Function Ministry (SFP) or the Internal Audit Entity of Pemex?

2. Enablement to carry out the assigned role

The two main problems that existed before the passage of the “reforms,” are still in existence and are still considered to be the largest impediments to the good performance of the company. They are a 1) a highly bureaucratic management structure, and 2) a high level of politicization within the organization.

For instance, appointments to Pemex management, regulatory commissions, Pemex-related boards, etc., depend on political decisions. In order to be appointed, individuals must demonstrate loyalty to the Executive Power (the President) or to the
Political Parties who nominated them. Because of this process, loyalties tend to be in alignment with the interests of the nominating political body, and do not necessarily coincide with the best interests of the company. Given that the primary allegiance of the individual is to the political apparatus that provided him with his job, the individual will be reluctant to make decisions that run contrary to the desires of his “patron.” Thus the incentives embodied within this situation generate what could be considered to be a kind of “latent red tape.” That is to say, the individual in a position of management has the power within his sphere of influence to exert a personal veto on any action that would run contrary to the prevailing interests of his political affiliation. And thus by exerting his “veto”, the individual gets to tangibly demonstrate his further loyalty to his “patron.”

In the same way, the high level of politicization surrounding the appointment of individuals to fill key positions also tends to lend itself to a lack of continuity of programs and policies. Additionally, the inability of policy makers to deal with the position of Unions vis-à-vis management tends to calcify the position of the Union.

During the reform negotiation process, no attempt was made to address the issue of relations between the Labor Union (STPRM) and the oil company (Pemex). As a result, words, the political roles of union leaders remained untouched and unchallenged.

In addition to the problem of cronyism previously outline, the lack of human resources to fill the newly created commissions is another issue which has not received any attention. In regards to the commissions (CRE and CNH), there is no specific guidelines as to how to choose technically qualified personnel who could staff the new oversight positions. Moreover, once appointed, these individuals will not have autonomy, as they will be at the mercy of the Ministry of Energy regarding staff and budget. On the whole, these commissions will not be regulators; rather they will only be technical advisors.

4. Transparency and accuracy of information

As for Pemex, the predictable weakness of the new commission designed to manage its oil well drilling for example, the National Hydrocarbons Commission (CNH), is that it will not have the capability to do its job. It will probably lack technically qualified personnel and it will surely lack sufficient autonomy, etc. Thus, the evaluation of the performance of the upstream program will continue to depend on the technical information provided by Pemex.

For its part, the ASF (Congressional Accountability Office) and the Congress are expected to play the same role as they did before. They will be wholly dependent on Pemex as their primary source of information, and that information will not be provided in a timely manner.

In conclusion, we can say that, in terms of Good Governance, the reform has not provoked any serious shifts. Many actors and stakeholders were quoted as saying only one or two weeks after the reform: “it has been a doable reform albeit not the desirable one”.

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However, perhaps, this severe conclusion could be nuanced by the fact that the
approved initiatives were only laws that needed to be realized through the writing (and
negotiation) of the several regulations. Taking this into account, the question is: What
progress has been made during the 2009 implementation work of the reform? And also:
Which have been until now the results and which impacts will they have for the future
of the company and for the Mexican oil industry?

5. Sustainable development for the benefit of future generations

Despite the efforts of the PRI to address sustainability, the reforms of 2008/2009
appear to address inadequately the issue of sustainability in the true sense, i.e., a
conservation and energy diversification. “Sustainability” in practice in the Mexican
context has come to signify finding new reserves to replace the ones currently declining
in production. From this perspective, true sustainability is unlikely to be achieved, but
only time will tell.

C. The 2009 implementation work of the reform

The first thing that is evident in looking at the implementation of the reforms is
the lack of concrete action to realize the measures, i.e. the creation of institutions,
formation of regulations, establishment of contracts, etc. Indeed, of the one hundred
actions planned for November of 2008 only 50% had been implemented at the end of a
one-year period.

For example, it took until May of 2009 to integrate the new institutions that
would be responsible for improving performance within the sector. These institutions
included: the Board of Directors of Pemex (the four new professional counselors in the
Board) charged with guiding the institution; the National Hydrocarbons Commission
(NHC) in charge of regulating the oil industry; and the National Energy Board, which
will be charged with carrying out the planning within the entire energy sector.

It took until June 27, 2009 for suppliers and contractors to the federal
government to be able to finally see the much-awaited reforms to the Law of Public
Works and Related Services, and to the Law of Acquisitions, Leases and Public Sector
Services. For its part, the new organic statute was approved on September 24, 2009; and
the related regulations were promulgated on January 6, 2010.

Certainly the implementation of reforms is an enormous task that requires a
great deal of administrative and regulatory creativity. It is also an area that does not lend
itself to haste. However, the possible loss of time during the period of implementation
has created costly delays resulting in the need to overcome a scenario of falling
production.
The delays have caused great tension between the Executive and Congress who have taken all opportunities call for the timely implementation of the reforms. It appears as though the spirit of dialogue and rapprochement that prevailed during the negotiation and approval process have not remained beyond its passage. These frictions have brought to light evidence of the different views regarding Pemex and the oil industry that predominate among stakeholders.

For some, the reforms have been more than sufficient; for others, they have been less than adequate. This last opinion explains why the Chief Executive of Pemex declared in September 2009 that it would be necessary to approve a new petroleum reform, more in alignment with the needs of the industry (This statement was spoken while the reforms of 2008 had yet to be fully implemented!) This statement may also explain why there was a change of directorship of Pemex announced by President Calderón at the beginning of September 2009.

As a lingering ghost from the past, the politicization of appointments to key positions remains a persistent practice. The naming of the four professional counselors, for example, has been the subject of negotiations and fights between the three main political parties (PRI, PAN, and PRD). Finally, the compromise that was reached was to divide the posts among the three parties, two for the PAN, one for the PRI, and one for the PRD. These appointments have served to polarize the loyalties within the Board of Pemex along political lines. Interestingly, this type of behavior runs diametrically contrary to the spirit of the reforms that the three parties worked so diligently to establish. Moreover, there has been an official recognition that was an over-enthusiastic optimism in the creation of committees; and it has been recently estimated that there are too many of them.

On the part of the CNH, its president has been nominated in base on his loyalty to the Minister of Energy (Dra. Georgina Kessel) rather than on his knowledge about the subject of regulation. This behavior reduces the ‘de facto’ autonomy of the CNH.

Also, the role of the commissioners and the CNH has not been well defined. This situation provoked (in the case of the CNH) several months of discussions amongst the commissioners to come to an agreement on what should constitute an upstream regulatory body. Equally, the responsibilities of the professional counselors have not been well defined, and that has resulted in great dispersion of the work that they have had to perform.

For new contracts, there have been various inconsistencies. First, the concept of substantive productive projects has been very vague; and it seems that any contract can fall into this category. This imprecision in the contracting process is problematic in that it reintroduces—to a certain extent—the possibility of discretionary manipulation. In effect, contracts for ‘substantive activities’ have the possibility of being awarded through ‘direct adjudication’ or through ‘restricted invitation,’ rather than the tendering process.

In contrast, the new proposal for contracts contains elements that go beyond what is provided for by law (defining what is and what is not a “state enterprise,” what

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7 Dr Juan José Suárez Coppel was appointed as the new General Director of Pemex replacing Dr. Jesús Reyes Heróles, encouraging signal shift in the orientation of the company and industry.
is or is not a "public service," and what lies beyond this definition). This has been interpreted by some actors and political forces as being unconstitutional, thus returning the subject of contracts to the realm of constitutional controversy. An additional shortcoming of the law is that it has not addressed an essential tenet, namely to provide security to contractors regarding rescission (or annulment) of contracts in the case of disputes (specifically, the terms of rescission/annulment).

The combination of the fall in production as well as the mix of crude that Mexico exports has contributed to more than forty percent of the public deficit for 2010; and this is expected to persist into future years. This situation is expected to have consequences on the amount of funds available to Pemex for investment, especially if one considers that the company will have to employ its own resources to address the liabilities generated by their previous infrastructure projects (as a result of the withdrawal of their previously employed ‘off the balance sheet’ financing scheme known as Pidiregas)\(^8\).

In addition, projects may no longer be funded by private entities, and may only be funded by the Federal Expenditure budget. Undoubtedly, the coming generation of liabilities and interests as well as the accumulated debts will become points of contention, and will provoke questions and claims between the various political groups operating in the Congress.

**Conclusion**

These are just some of the issues that have surfaced as a result of the Reform. Given that this process has been long and drawn out, it is difficult to assess at this point in time in what way, and to what extent, the Reform has been beneficial. As many of the regulations have recently been promulgated, it is too early to draw a conclusion. Even though many of the Reform measures are headed in the right direction, it seems as though they will have little affect on ameliorating the enormous challenges facing the Mexican oil industry in the present day.

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\(^8\). In effect, the Reform established that all of the liabilities of the ‘off balance sheet’ Pidregas scheme be converted into budgetary debt of the organization, and that the liabilities henceforth would not be amortized as Expenditures of the State using budgetary resources as had been previously practiced. In that way, it was specified that Pemex use its own resources to amortize part of the liability.


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