since the December 2012 inauguration of president enrique pena nieto, Mexico has implemented a series of reforms that could forever change Mexican governance and its economy’s competitiveness. These include new rules to enhance government transparency, reform primary education, expand access to credit, and encourage market-based competition by promoting investment and strengthening regulatory authorities. But the undisputed centerpiece of the legislation is energy reform.

It is not an exaggeration to call Mexico’s energy reform revolutionary. It will break the monopoly of pemex, the state-owned petroleum company, and for the first time in over half a century, allow foreign private investment in almost every corner of the Mexican energy market. Such a reform promises to revive the Mexican oil industry, likely leading to lower-cost energy production and significant economic growth. And that is only the beginning. The energy reform package also contains three key elements -- generally overlooked in recent commentary -- that may well signal changes in the Mexican economy every bit as transformative as the Mexican Revolution of almost a century ago.

The restructured energy sector, despite its openness, will still be very much in line with the spirit of the Mexican Revolution: The state will continue to manage key aspects of the energy market, and pemex will still be the dominant player in the sector. But Mexico’s willingness to embark on a profound restructuring of its energy sector reveals that the country is continuing its transformation into an increasingly self-confident and important player in the global economy. And, reform means that energy will soon become a central part of the NAFTA-driven economic integration of North America and a source of North American energy security. As a result, Mexico’s energy reform will deepen and strengthen its economic partnership with the United States.

National Champion

The most significant -- and controversial -- elements of Mexico’s energy reform are those that will end pemex’s monopoly on petroleum exploration and production and open the sector to private (including foreign) investment.
The Mexican government will still own Pemex, but it will operate the firm as a “state productive enterprise,” which will have to compete with international energy companies in the Mexican market. This is a stunning change.

The oil industry was nationalized in 1938, and since then, national control of petroleum resources has been a core component of Mexico’s sense of sovereignty. The nationalization, which included the absorption of property owned by U.S. oil companies, was the first time Mexico directly challenged the United States and got its way. Since then, state control of energy resources has been a key symbol of Mexican nationalism and sovereignty. Further, Pemex has also played a vital financial role for the state. Its revenues cover about a third of the federal budget (to say nothing of the opportunities it has provided for patronage).

For decades, the political untouchability of Mexico’s petroleum resources blocked much-needed reforms and imposed an onerous opportunity cost on the country. The Mexican oil industry had long ago lost is ability to be a powerful driver of the country’s economic development, because Mexico’s distinctive brand of resource nationalism kept the latest know-how and technology out of the local oil industry, which held back production and diminished revenue.

Decades of evident inefficiencies and corruption in Pemex, years of declining oil production, and changing attitudes about the United States gradually undermined popular opposition to allowing foreign investment in the petroleum industry. Now, for the first time in 50 years, Mexico could get the vibrant oil sector it needs.

In addition to entering the oil markets, the private sector will now be able to produce and sell electricity in a free market. Much like Pemex, the state-owned Federal Electricity Commission (CFE) will compete with private firms to sell electricity into the grid. The CFE will also have the authority -- previously a Pemex monopoly -- to import and re-export natural gas, as well as to buy and sell it in the domestic market. That will be an important step forward for the CFE, which uses natural gas to generate much of its electricity.

The electricity reform also allows the government to contract with private firms to expand the country’s energy transmission and distribution network. Further, it transfers management of the wholesale electricity market from the CFE to an independent agency, although transmission itself will remain under government control. Finally, it encourages the development of renewables in a country with enormous potential for solar, wind, and geothermal energy, and sets ambitious goals to derive up to 35 percent of electricity from clean and renewable sources by 2025. Over time, these changes should translate into cheaper electricity for Mexican consumers and business, which could dramatically enhance the productivity of the country’s already ascendant manufacturing base.

WE’LL MANAGE

Although the reform carved out a larger role for the market in the energy sector, the Mexican government retains its revolutionary and statist DNA: It is still authorized by the constitution to use the country’s land and water resources for the benefit of the nation. Indeed, although most of Mexico’s post-revolutionary governments have promoted private property and investment as motors of economic growth, they have never hesitated to intervene in the market to meet the government’s view of the national interest.

Today the situation is quite different. More than a quarter century after implementing more market-friendly economic policies, the Mexican government’s willingness and capacity to regulate private property is the lowest it has been for a century. Even so, its sense of responsibility regarding managing key resources remains strong, which is reflected in
the following three aspects of Mexico’s energy reform.

First, the government has decided to allow risk contracts in petroleum exploration and production, albeit through a legal sleight-of-hand. Unlike the service contracts previously used in Mexico, risk contracts base earnings on actual production rather than on services rendered (a pre-requisite under U.S. securities regulations for a company to declare the petroleum an asset). Risk contracts generally take the form of concessions, which grant private companies ownership rights to a petroleum reserve. But in Mexico, continued national ownership of the petroleum in the ground was a political prerequisite for approval of the reform, so the government invented a brand new category of contracts -- licenses -- which permit private ownership after the petroleum leaves the wellhead.

Second, beyond empowering the government to select the fields that will be put up for bid, the reform allows the Energy Ministry to establish contractual terms (service, production-sharing, profit-sharing, and licenses) and the Finance Ministry to set the fiscal terms (fees, royalties, and tax rate) under which each individual field can be exploited. The common international practice is for governments to establish bidding terms by asset class (deep water, shallow water, shale, and so on). The Mexican government justifies its bid structure as necessary to ensure that the investment and tax regime matches the specific characteristics of each field. Although this logic is not incorrect, it also reflects Mexico’s statist heritage.

Third, the reform transforms Pemex into a “productive state enterprise” rather than privatizing it or even allowing limited private ownership of the firm through stock purchases. In addition, it gives Pemex the exclusive right to work 83 percent of Mexico’s currently producing fields and 21 percent of its prospective reserves. The reform thus reflects the federal government’s desire for Pemex to remain the dominant player in Mexican exploration and production.

INTEGRAL INTEGRATION

Mexico’s energy reform might be rooted in the statist values of the Mexican Revolution, but it also confirms that Mexico is becoming an increasingly self-assured and credible player in the global economy. And in this sense, the recent reform may well set the country on an entirely new and revolutionary trajectory. Continuing a trend that started over 20 years ago with the creation of NAFTA, the reform further expands the role for private foreign capital and the free market in Mexico. Pemex and the CFE will now have to compete with global players with the implied confidence that they will succeed, and potentially even thrive.

As Mexico opens up its energy sector, the reform could change U.S.–Mexican relations for the better. Petroleum, the most significant remaining bastion of Mexico’s historic anti-American nationalism, is poised to become a powerful tool for further integration and partnership. Indeed, Peña Nieto’s energy reform is a reflection of how much popular sentiment about the United States and petroleum has changed. There is, of course, significant opposition to allowing U.S. investment in Mexican petroleum and extending Mexican reliance on the United States to the energy sector. But this opposition is likely to weaken over time, much as opposition to free trade and deeper economic integration with the United States declined with the implementation of NAFTA.

The decision to open energy exploration and production to foreign investment is also expected to lead to the informal inclusion of energy into NAFTA-propelled economic integration. Indeed, the process is already underway with the construction of two natural gas pipelines to bring U.S. gas into Mexico. And soon, with a revival of the Mexican energy industry, the United States will be able to turn to Mexico and Canada to ensure U.S. energy security rather
than relying on troubling partners in the Middle East and Africa.

From a broader economic perspective, energy reform in Mexico -- and the deeper energy integration with the United States it will create -- promises to magnify the economic benefits of the shale revolution. The result should be a pronounced global competitive advantage for North America. In the near term, Mexico’s new energy policies should significantly reduce the cost of natural gas and electricity for Mexican manufacturers and further increase their productivity. In the longer term, increased Mexican energy production will flow into the North American market reinforcing regional energy independence and security. And a more secure and integrated North American energy market will reinforce North America’s global competitiveness as a manufacturing and production center.

FIND THE ENERGY

The United States and Mexico are actively collaborating on enhancing North American competitiveness through the launch of the new High Level Economic Dialogue, which is based on the idea that both countries are strategic economic partners and should act that way, collaborating on a range of initiatives to promote innovation, connectivity, and competitiveness in North America. Energy is, and must be, a central part of that agenda because much still needs to be done to achieve energy independence in North America. The region needs a common market structure, harmonized regulations, and even deeper infrastructure integration. It will also need more technical exchange, access to investment capital, and many more engineers, geologists, and geophysicists to develop all the new energy plays in North America. Mexican energy reform has clearly jump-started this process.

Having overcome the political stalemate that long blocked needed policy change, Mexico appears poised for rapid growth in the energy sector and beyond. This growth will continue to reflect Mexico’s more statist approach to managing its market economy. At the same time, though, the increasingly self-confident Mexico revealed by the energy reform opens the door to deeper collaboration with the United States. With a new North American energy future on the horizon, Mexico is a willing and able partner. As a result, both the United States and Mexico -- together with Canada -- have the opportunity to boost North American global competitiveness and jump-start the region’s economies.

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