



Multiple Services Contracts A Failed Opening in Fossil Fuels

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In July 2003, Mexico's oil giant Petróleos Mexicanos (Pemex) called for bidding on the exploitation of natural gas in the vast Burgos Basin, 13,000 square kilometers covering parts of the states of Coahuila, Nuevo León and Tamaulipas. It is the largest private investment program ever launched by the

government and, because of its financial size and political aims, should be considered central to President Fox's endeavors.

It was designed to partner Pemex with the world's large oil companies in order to satisfy the country's natural gas needs over the next two decades. However, it caused such heated debate that Pemex could not call for bidding earlier, despite being authorized since 2002. And it is not that it was a bad business

deal. On the contrary, participants will make considerable profits since the contracts will be guaranteed by the state (through programs with differed impact on expenditures known as *Pidiregas*) and the trends in gas prices are very attractive. In addition, enough exploration has been done in the area to be reasonably certain that sufficient quantities of gas will be found to attract investors. So, the problem is not the financial viability of the projects, but rather their legality and

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what they could lead to in the national oil industry.

Practically from the start, the Fox administration announced the strategy of opening the fossil fuel and natural dry gas sectors to private investment, covering exploration, extraction, processing and transportation in a single contract so that a single operator could carry them all out in a given territory ceded exclusively by Pemex. This way of organizing the participation of private companies in the oil industry was justified as a simple matter of administrative efficiency, consolidating many contracts into one. However, this kind of creativity weakens Pemex's constitutional mandate to exploit fossil fuels within Mexico's borders.

Opening up to private capital was announced using the by-now typical argument that Pemex did not have the money needed to increase the gas supply and satisfy the demand that in recent years has spurred gas imports to increase to 20 percent of national consumption. Pemex management carried out an ample campaign abroad to attract large companies specialized in these activities so that they could contribute not only capital, but also technology that would help develop this sector, so strategic for the country.

The project consisted of drilling 822 exploratory wells, 4,250 development wells and processing a billion cubic feet of gas a day. The investment would come to U.S.\$10 billion over 15 years. Earnings would be U.S.\$14.911 billion; outlay for amortization, financial costs and operations would come to U.S.\$13.424 billion; and profits before taxes would be U.S.\$1.487 billion. That is, at the most, the Mexican state would receive 9.9 percent of the earnings from exploiting its gas reserves for

20 years. What is more, the flow model that the administration sent Congress takes the price of gas as key, establishing an average of U.S.\$3.39 per thousand cubic feet. While it is true that coming up with a price estimate for 20 years into the future for a fuel as linked to oil prices as this one will always have a high margin for error, this very consideration should lead us to think that if the price of gas were 10 or 15 percent lower than average, the project would no longer be profitable for the state and the only ones to benefit would be the private investors.

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Even though the contract clauses have been modified to eliminate some problems, they still establish, for example, that for the contract to be upheld, Pemex will not replace or participate in the works carried out by the contracting company. In that sense, Pemex is prohibited from exploiting the area signed over in the contract; the contracting company can later use the knowledge and information derived from Mexican fields; the national content is very vague and does not stimulate the inclusion of capital goods, other equipment and nationally produced inputs. This last point is very important because the development of the national energy sector must be seen as a lever for fostering the country's industrial development; otherwise, fossil fuels could again become enclave economies for export or create grave technological dependence.

Pemex will only play an administrative role: it will request and receive

reports; it will do the accounting, sell the gas and pay the company that carries out the actual work. Therefore, the public body that by law represents the Mexican state in the exploitation of fossil fuels is de facto being replaced; this is the center of the legal discrepancy that the courts would have to decide if some legislators' objections were taken to trial.

The authorities maintain that Article 6 of the legislation about oil allows for signing contracts with private companies or individuals and that, today, they have hundreds or even thousands

of them covering different oil industry needs. They also maintain that the Constitution only prohibits risk contracts and that, in this case, the state will always keep control over any fossil fuels that might be extracted.

Certainly, Pemex has signed a large number of contracts for acquiring inputs, material, equipment and services from many private companies, as is to be expected from a company that does more than U.S.\$20 billion a year in business. The problem lies in that, in this case, we are referring to a contract that grants all exploration, extraction and transportation activities to a single contractor who has exclusive rights for the life of the contract in a specific area, even excluding Pemex itself.

Article 6 that Pemex's lawyers cite must be read together with the preceding articles. Article 2 says that "only the nation shall exploit the fossil fuels that make up the oil industry"; Article



Andrew Winning/Reuters

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3 stipulates that the oil industry includes exploration, exploitation, elaboration, storage and first-hand sale of these kinds of products; Article 4 specifies that all these activities will be carried out by Pemex and its subsidiaries. The logic of the text makes it clear Pemex can sign any contract to rent equipment or retain specific services as long as they do not involve the exploitation of fossil fuels.

In this debate, it has also been said that the 1960 reform of paragraph six of Article 27 of the Constitution that included the phrase, “neither concessions nor contracts shall be granted, nor shall any that have been granted subsist,” was incorporated in strict reference to risk contracts. This is not exactly the case, since the *Diario de los Debates* (Congressional Record) reports a discussion about the reviewing com-

mission’s decision on whether or not to maintain the term “contract” in reference to mining in order to better protect small miners. But with regard to oil, the deputies were clear, when Deputy Enrique Sada Baigts said, “When speaking of the country’s oil, the commission will never accept opening the door, leaving the signing of contracts to the discretion of the public administration.”¹ As can be seen, at no time did the legislator make exclusive reference to risk contracts. On the contrary, the main aim was to protect the state’s exclusive right over the “exploitation” of oil.

Regardless of these legal questions, the proposed contract does not benefit Pemex. And I am not referring to the financial question, but to the wealth of technical-scientific knowledge, since by being excluded from direct exploitation, Pemex will have to share strategic

information about deposits, will not train personnel nor have the opportunity to broaden its technological knowledge. And this is vitally important, since clearly the strength of a world-class company is not only its financial capability, but also its command of technology and specialized knowledge, two factors that determine how it evolves.

Seven blocks of territory in the Burgos Basin were bid for. This is the most productive of the country’s four dry gas basins.² Investors were given studies of prospecting, wells and installations that not only established the certainty of large gas reserves but also made it possible to begin extraction very quickly. However, none of the large multinationals participated and two bidding processes ended without awarding a contract to anyone. For the five blocks assigned, promises of investment for U.S.\$4.3 billion were made over a period of 15 to 20 years, to produce 425 million cubic feet of gas a day. Three years later, this government program had reached less than 50 percent of its initial target. Of course, the non-assigned blocks could be adjusted and perhaps assigned, but there is very little chance that they will attract the kind of companies originally intended. We should remember that the only “major” that came in was Exxon-Mobil, but it bowed out from the beginning and did not bid again. Finally, it was Repsol and Petrobras, two medium-sized companies (smaller than Pemex), that contributed the capital and technology that, according to Mexican authorities, Pemex cannot supply.

Actually, the blocks that were not awarded are the largest and the ones with the biggest reserves, and they require very large investments, viable only for the world’s largest companies, which

have already shown their disinterest because the deal offered does not allow them to write Mexican gas reserves into their books as assets nor does it give them sufficient control over the product. In fact, Repsol and Petrobras may have participated precisely because their size leads them to accept projects for the sale of services and because they have also made a priority of increasing their presence in Latin America.

According to public information from the Pemex Exploración Producción's Northern Region, between 1997 and 2001, Pemex had invested U.S.\$2.826 billion in the Burgos Basin, and had sales for U.S.\$4.912 billion, reaping U.S.\$1.176 billion in profits. That is to say, it invested over U.S.\$700 million a year (a figure double that which the multiple services contract holders have promised to invest) and made an average of U.S.\$294 million annually, contributing almost an additional 500 million cubic feet a day. In the light of these figures and the results up until now, it is difficult for the defenders of multiple services contracts to justify this strategy as the best one for developing gas extraction for consumers.

Pemex management has said that the strategy for including private companies in natural gas extraction has been satisfactory and that new multiple services contracts will be signed for developing the Coatzacoalcos, Gas Terciario and Cuichapa projects in Veracruz and Tabasco states, both at sea and on land. But the facts point to the opposite conclusion. The strategy of operating the fossil fuel sector with private capital and management is stymied in its own inconsistency: it is insufficient for attracting players big enough to make it viable since the big multinational corporations only participate when they

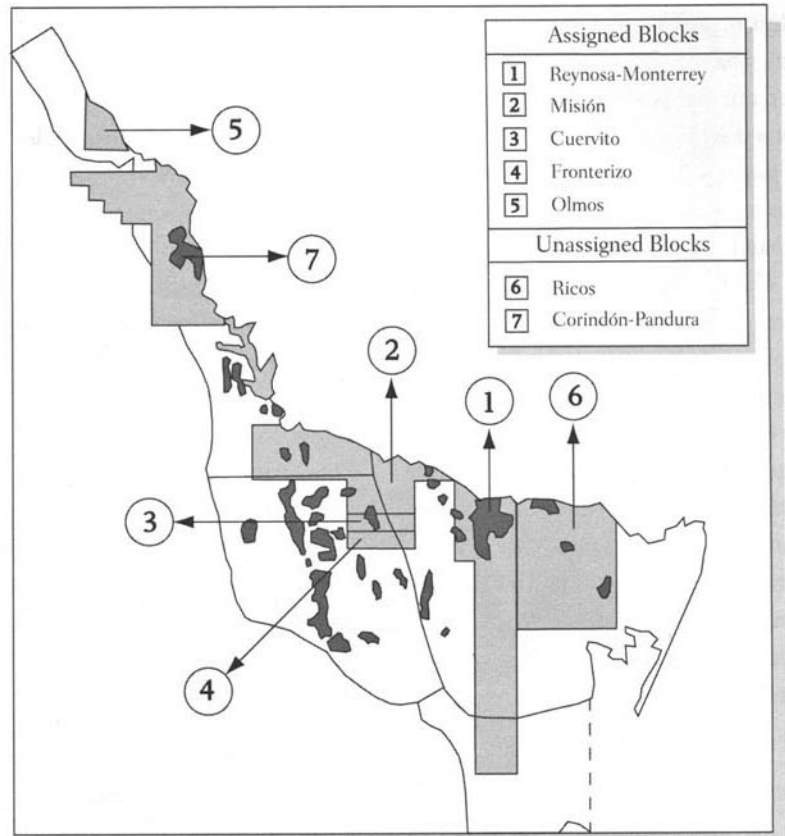
can take the lion's share, and legally, it cannot go any further because of the risk of being declared unconstitutional.

It may not be premature to say that opening Mexico's fossil fuel sector to private investment has been a failure and to relearn the old lesson that the multinationals do not participate if they do not have complete control over the operation. As a result, Pemex must seek self-sustaining alternatives or global agreements with companies that offer advantages in specific items where it really needs them.

It is possible to satisfy the demand for gas without selling off the country's

natural resources too cheaply if we take a look at public companies' potential and aim to turn them into global companies. We just have to think about the fact that in the first quarter of 2004, tax revenues from oil came to more than U.S.\$9 billion and the Fund for Stabilization of Oil Earnings has more than an additional U.S.\$600 million that could be very useful if the policy focus of forced liberalization of the sector changed.

It would even be more profitable (and appropriate for both economic and environmental reasons) to stop massively burning off gas in the Gulf of



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Mexico, particularly in the Cantarell project, which comes to more than 200 million cubic feet a day. Congress should set a deadline for stopping the burning of gas in order to take full advantage of this natural resource that today is simply wasted.

The federal government decided to move ahead by itself in this sensitive area toward private investment, despite criticism from Congress that will broaden out and sharpen with time, making it possible for the first time since the 1938 oil expropriation for foreign companies to take charge of exploration, extraction and transportation of fossil fuels. Instead of shunting Pemex to one side, why not broaden out the vision to establish common business ventures,

bigger alliances in which the private companies can obtain larger profits at the same time that Pemex does, and even to include small and medium-sized Mexican companies?

Actually, Pemex requires a profound structural reform so it can be more flexible and capable, not only of getting the financing it needs, but also of establishing the partnerships that its modernization requires technologically. But this reform will hardly be possible if the changes are forced ones. Legislative consensus will be blocked from the get-go if Congress has the impression that the administration wants to impose its will even at the cost of violating the fundamental law of the land. **NM**

NOTES

¹ "With regard to oil...we think it should be settled once and for all in Article 27 of the Constitution that neither concessions nor contracts shall be granted, nor shall any that have been granted subsist, and that only the nation shall be able to exploit these products in the terms that the respective legislation stipulates; because despite the fact that the Constituent Congress's aim has been clear, after the December 1939 reform completely removing oil exploitation from the regimen of concessions or contracts, when it was passed, the corresponding regulations once again sparked a legal debate about the subsistence of some concessions or rights of private companies or individuals to exploit oil. Therefore, to avoid any further controversy, the reform should proceed." *Diario de Debates* (Mexico City), 22 October 1959.

² The other three are Veracruz, Macuspana and Lankahuasa on the Gulf of Mexico continental platform.

ERRATA

In issue 67 of *Voices of Mexico*, in the "Economy" article "Mexican Foreign Trade in Trouble, China's Impact" by Gerardo Bracho, there are three mistakes:

- Page 50, paragraph 2, lines 10-12 read, "U.S. exports grew by 8.4 percent, but Mexican exports to the U.S. only by 1.6 percent." It should read, "U.S. exports grew by 8.4 percent, but Mexican exports to the U.S. only by 2.6 percent."
- Page 50, paragraph 3, lines 10-13 read, "U.S. imports from China were on average 26.6 percent higher than their 2000 level, those coming from Mexico were on average 0.8 percent lower." It should read, "U.S. imports from China were on average 26.6 percent higher than their 2000 level, those coming from Mexico were on average 2.9 percent lower."
- Page 55, Graph 4, the part of the key that reads

Imports U.S. Imports other countries
 should read
 Imports U.S. Imports other countries

