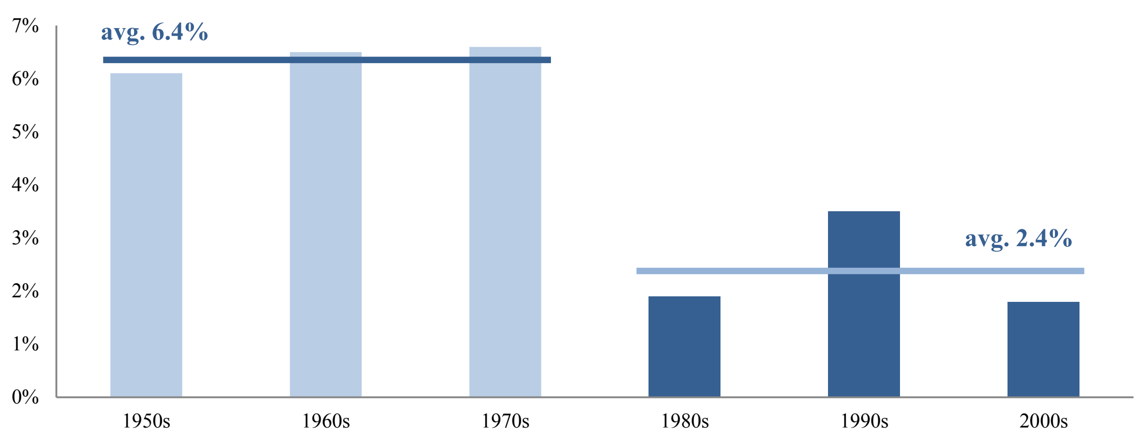
REFORM DRIVERS

Broader economic needs coupled with industry stagnation and structural challenges spur reform

Energy reform is part of a wider set of sectorial reform initiatives of the Peña Nieto Administration. All of them respond to the urgent need to increase the rate of economic growth and improve productivity. Performance over the last thirty years has been disappointing with respect to its own history and relative to other middle-income countries. After growing from 1950 to 1980 at an average annual rate of 6.4 percent, GDP grew from 1980 to 2010 at a rate of 2.4 percent. More recently, average growth has been even slower. Notwithstanding the increasing flow of direct private investment, gross fixed capital formation has remained stagnant as a proportion of GDP, at levels just above 20 percent. Insufficient investment in public goods is the source of serious bottlenecks in physical and social infrastructure, and effective non-oil tax ratios are particularly low, even by Latin American standards, at less than 10 percent of GDP. Maintaining macroeconomic balances has resulted in a severely capital constrained state-owned energy sector. It is thus not surprising that a poor state tends to have poor state-owned capital-intensive energy companies.

Mexico Annual Real GDP Growth
In constant 2012 dollars; compound annual growth rate

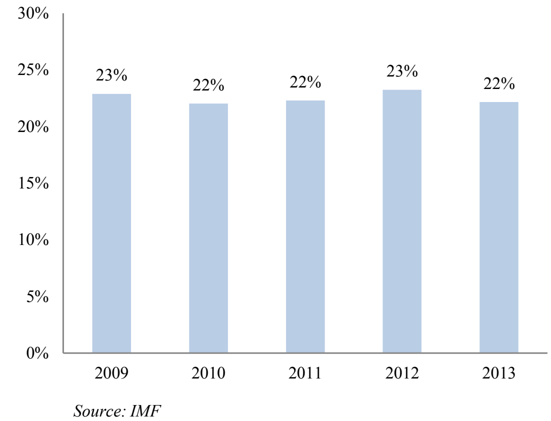


Source: McKinsey Global Institute, IMF

Mexico Non-Oil Tax Revenues
% of GDP

Source: IMF

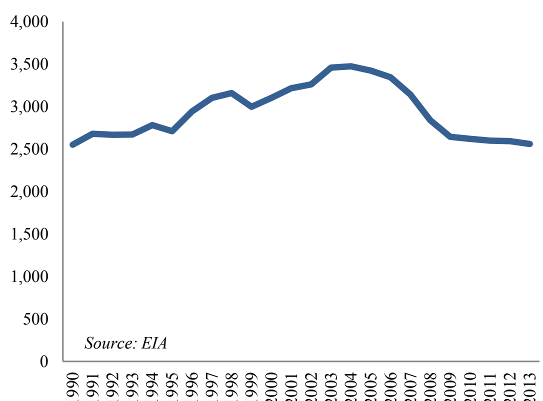
Mexico Total Investment
% of GDP



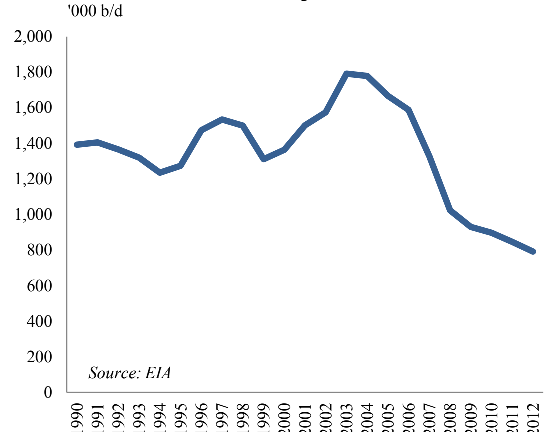
Source: IMF

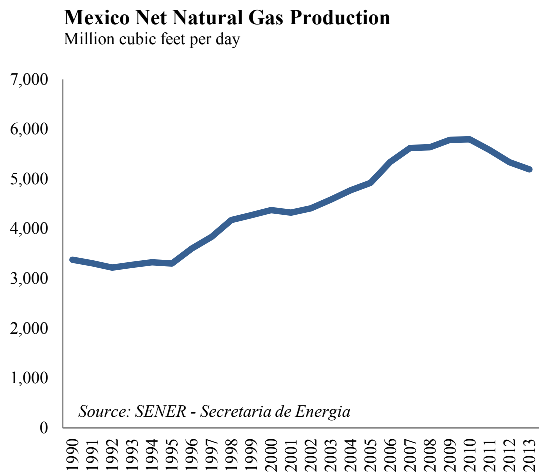
Other more immediate drivers of energy reform have been the dramatic fall in crude oil production and exports in the context of the recent expansion of oil and gas production in the rest of North America. Net domestic natural gas production has been stagnant for some time. The resulting increase in imports has been insufficient to meet demand due midstream problems, specifically pipeline capacity constraints, which have provoked a serious natural gas supply crisis. Uncompetitive electricity costs and prices are limiting the growth of manufacturing. More generally, a sense of crisis prevails in the energy sector, particularly in the oil industry, where governance issues are blamed for underperformance.

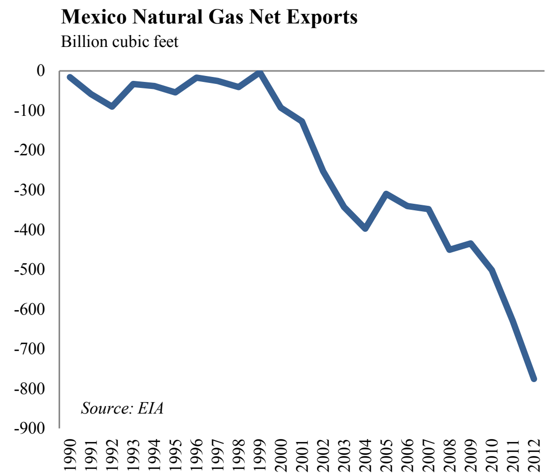
Mexico Crude Oil Production
'000 b/d



Mexico Petroleum Net Exports
'000 b/d







Secondary legislation and enabling law initiatives that relate to the energy sector were sent to Congress on April 30th, as ordinary sessions were ending. They are being discussed in committees, and the government seeks to have them approved by the end of June, in an extraordinary congressional session. The proposed legislation gives greater granularity to the desired structural changes and sets the stage for policy and strategy developments in oil and electricity. The new laws seek to reform the energy sector by:

- Redesigning existing institutions, as well as the creation of new ones
- Curtailing and substituting direct government intervention with regulation
- Strengthening the role and independence of regulators
- Establishing independent system operators to manage transmission, transportation and distribution grids, and,
- Proposing new governance structures and processes for Pemex and CFE

The entry of new industry players requires that basic decisions with respect to these issues are clear and explicit.

This paper discusses the objectives, the scope, the depth, and the timing of energy reform. It argues that a more realistic assessment of medium-term domestic oil and natural gas production prospects is required. The expected growth of oil product and natural gas imports, primarily from the U.S. Gulf Coast, are part of the shifting North American energy reality that must be analyzed and fully understood in developing reforms, as imports are bound to play a key role in creating a more competitive market environment in Mexico. [1]

The paper outlines the complex issues that are posed by the proposed upstream oil and fiscal regime as well as the challenges of the changes in midstream electricity, natural gas, and liquid hydrocarbons sectors. The speed of refined product and electricity liberalization is addressed, particularly in the case of automotive fuels.

Finally, the importance of reform of the electricity sector for manufacturing and the wider economy is stressed The oil upstream proposals have generated a great deal of attention, but reducing costs, tariffs, cross subsidies, and expanding the transmission and distribution grids could have a more direct and immediate impact on the competitiveness of Mexican industry.

The paper concludes that a deeper congressional review of several reform measures would ultimately bolster the process and ensure that Mexico reaps the maximum benefits. In addition, a more democratic approval process would add to its legitimacy and strengthen public opinion. Allowing time for a fuller discussion might delay final approval into the summer, but it could be done before the next ordinary session at the beginning of September.

[1] Adrian Lajous, Exportaciones de petróleo crudo de Estados Unidos a México, *Foro Internacional*, Vol. LIV, julio-septiembre, núm 3.