



BULLETIN SUMMER 2008



DIAGNOSTIC: SITUATION OF PEMEX

I. INTRODUCTION.

CURRENT SITUATION

Currently Mexico is experiencing an intense political effervescence, immersed in the inadequately named Energy Reform. In fact, what is happening would more appropriately be referred to as a structural reform of the oil industry. The process, which is now in the phase of legislative approval, began the end of March when the federal government released for purposes of beginning the public debate the document entitled "Diagnostic: Situation of PEMEX". The dissemination on line of this diagnostic, a merely informative document prepared by the Ministry of Energy and PEMEX itself, was followed by the formal presentation of a bill with 5 legal reforms to different laws (currently in discussion in the Congress) and will culminate with the issuance of the legislative reform decree resulting from the legislative discussion and political negotiation. Below you will find as a first step a summary of the contents of the Diagnostic. Later we will present an analysis of the specific contents of the reforms proposed in the second episode of this interesting history.

By Constitutional mandate, the oil industry in Mexico is reserved as a State monopoly under the aegis of a state body: PEMEX. Petróleos Mexicanos (Pemex) is the public decentralized body exclusively responsible for carrying out the strategic activities in relation to hydrocarbons reserved in the Mexican Constitution. It is an integrated company, participating in the entire value chain of the industry (exploration and production; refinement of crude oil; processing of gas and basic petrochemicals; and, production of certain secondary petrochemicals). Its purpose is, or should be, to maximize the long-term economic value of the hydrocarbons for the country. But profound adjustments to the regulatory framework are needed, as the company is showing significant signs of decline. According to the Diagnostic, Pemex went from being the sixth most important oil company in the world in 2004 to being the eleventh in 2007. Thus the state oil company urgently needs indispensable changes.

In this context, the principal challenges for PEMEX consist primarily of:

- Sustain for the medium term the production platform;
- Efficiently administer the decline of the principal oil fields;
- Substitute this decline with hydrocarbons from more dif-

ficult basins;

- Increase the proven reserves in order to sustain the level of production in the medium and long term;
- Reduce the participation of imports in the offer of petroleum products;
- Increase productivity and improve its operative performance;
- Improve its oversight, transparency and accountability without obstructing its operations and functioning; and,
- Correct its financial disequilibrium in order to guarantee its viability.

In summary, the challenge for PEMEX is not only financial, but fundamentally operative, technological and operative capacity. This clearly shows that its regulatory framework must be adjusted. The manner in which the changes required are noted is a profound change in its model of industrial organization in order to strengthen it, giving it operative flexibility in different areas and permitting modern, effective schemes for collaboration with third parties, in order to have access to the know-how and technological development that will permit them to maximize the value of oil earnings.

II. CURRENT CHALLENGES FOR OUR OIL INDUSTRY

Pemex confronts considerable challenges in each of its lines of business:

A) EXPLORATION AND PRODUCTION

1. RESERVES.

The hydrocarbon reserves have been decreasing since the mid-eighties. The decrease has been dramatic: currently the country has proven reserves for 9.2 years at current levels of extraction. The registered decrease in production means that Mexico ceased to obtain in the last 3 years an accumulation of income from sales of around 10 billion dollars, considering the average annual price of oil for the period.

The strategy for maintaining the levels of production in the short and medium terms, and to substantially improve the rate of restitution of proven reserves, must consider five elements:

- Discovery of new fields from prospective resources;
- Putting new fields into production;
- Development of fields with probable and possible reserves;

- Optimization of the costs of production, discovery and development; and,
- Efficient administration of the decline of the deposits in exploitation.

2. PROSPECTUS

With respect to the proven reserves, 83% of them are in fields in clear decline. This has translated into the already mentioned fall in production of crude. The only region that will not present a decline in the medium term is Chicontepec, since it is a project in the initial stages.

Faced with this reality, there are four areas of oil exploration that must be worked on in order to maintain the production platform in the medium term:

- Exploration and development of the resources in the southeast basins;
- Exploration of abandoned fields;
- Development of the paleocanal of Chicontepec; and,
- Exploration and development of the deep waters of the Gulf of Mexico.

As part of the recuperation of the production from these resources it is expected that the Southeast Basins present production costs superior to the current ones, since they are smaller basins than the current ones; the abandoned fields will only contribute marginally to the increase in oil production in the coming years and only for a short period. Chicontepec consists of wells with low productivity with development and exploitation costs significantly greater than the current average. Therefore, an oil exploitation policy that concentrates on the development only of Chicontepec and the southeast basins would be insufficient to sustain the current production platform. Even if these two projects are successfully executed, there would be a deficit of around 500 thousand barrels daily by 2021; this deficit, valued at current prices, is equivalent to more than 14 billion dollars annually. Therefore, initiating the development of the deep waters is essential.

Because of the maturation time for deep water projects, Pemex must initiate the development of this region on a large scale as soon as possible in order to be able to guarantee in the coming years at least the same production of hydrocarbons as there currently is and above all increase it to finance the accelerated development of the country.

The development of deep water fields requires the acquisition of knowledge in order to be able to administer and operate the new technologies that are used in these types of deposits and multi-

ply the capacity of execution. It is thus clear that in the medium term it will be necessary to multiply the capacity of execution of Pemex Exploration and Production, above all when it is a job representing high discovery, development and production costs.

On the international level, the report emphasizes that the possibility of finding deposits that are easily accessible, of low technical complexity and high relevance is practically exhausted. Therefore, the perspectives for hydrocarbon production are oriented in good measure to the deposits located in deep waters. This is so to the extent that, while 10 years ago the contribution of production in deep waters did not reach 1% of the total world production, now it is near 8%.

In this context, the report concludes, it is necessary for Pemex to be able to work with other companies in the development of various of its activities, under efficient mechanisms that allow it to obtain the best technology and lead to maximizing the oil revenue for the country.

B) REFINING

Pemex Refining engages in activities of production, transportation, distribution, storage and sale of petroleum products. It has the function of covering the national demand for petroleum products with its own production or imports. Its refining capacity, however, is insufficient to address the growing demand for petroleum in the country, which has required more and more imports. Therefore, significant and ongoing changes are required in the configuration and complexity of the refineries. It is also necessary to strengthen the existing infrastructure for storage and distribution of Pemex Refining.

The most important challenges that confront this subsidiary in the short, medium and long term are summarized in five lines of action:

- Increase the import capacity and strengthen the storage and distribution infrastructure, in the very short and medium terms;
- Reconfigure refineries
- Construct new refineries;
- Construct infrastructure to produce clean fuels; and,
- Reduce the environmental impact

In summary, it is necessary to promote the growth of refining capacity. In this respect, it will be necessary to construct new refining capacity in the next two decades in order to be able to close the gap in gasoline and refined petroleum imports.

C) GAS

Pemex Gas and Basic Petrochemicals (Pemex Gas y Petroquímica Básica) (PGPB) processes wet gas and condensed sour gas. It also participates in the transportation and distribution of natural gas and liquid petroleum gas (LP gas). In this segment, while the production of natural gas and LP gas is restricted to the State, their transportation, storage, distribution and sale is open to third party participation. However, an increase in the production of wet gas is expected and to guarantee its processing and satisfy the market requirements, it will be necessary to adjust the transportation infrastructure to make it more flexible, and to increase the processing capacity of PGPB. For this a complementary investment will be required in order to increase transportation capacity, introduce flexibility to the national system of gas pipelines, and construct supply infrastructure, in order to insure supply in the country and establish redundancies in the system.

D) PETROCHEMICALS

Pemex Petrochemicals (Pemex Petroquímica) (PPQ) is the last of the links in the chain of businesses in which Petróleos Mexicanos participates. Its basic activity is the production of non-basic petrochemicals derived from the first transformation of methane, ethane, propane and naftas, from which products such as the polyethylene, chloride of vinyl or oxide of ethylene are obtained, which in turn are inputs used by the national productive plant to produce different goods.

The segmentation of the chain between basic and secondary petrochemicals has slowed down the production of the latter. The basic petrochemicals are produced exclusively by the State, while for the secondary petrochemicals, the law contemplates the possibility of third party participation. Since the basic petrochemicals are raw material for the production of the secondary petrochemicals, there is a nonintegrated production chain. This is different from the international experience where a vertical integration of these activities can be seen. The above has made it difficult to guarantee the supply of raw materials to the secondary petrochemicals, which has limited its development and discouraged investment in projects.

The development scheme consists of providing legal security to investors, through a long term supply agreement and the establishment of a financially viable price mechanism, according to the cycles of this sector.

E) EXECUTION CAPACITY

The above described challenges, particularly in exploration, production and refining, require Pemex to multiply its execution capacity and develop the know-how to administer new technologies. It is a necessary condition to allow Pemex greater flexibility to contract third parties and thereby take advantage of their experience and capacity, by mechanisms of collaboration with companies with complementary experiences and skills. Other state companies have successfully confronted similar challenges as those faced by Pemex.

In this regard, it is fundamental to adjust the regulatory framework of Pemex to provide it with agile and modern mechanisms for its operation. This implies having an operative and management framework that gives it greater decision-making authority in contracting so that it can multiply its operative and execution capacity and obtain better technology.

F) FINANCIAL CHALLENGES

The financial situation of PEMEX is worthy of attention. At the close of 2007 the total debt of Petróleos Mexicanos came to 50 billion dollars, while its labor debt altogether came to 52 billion dollars. Therefore, one of the challenges of Pemex is to improve the investment financing structure: more of its own resources and less indebtedness. This strategy should be strengthened with complementary investments in those areas of the oil industry not reserved to the State. The financial challenge for the company consists of correcting its structural disequilibrium and financing better, healthier investment. For this the following is necessary:

- To substantially increase the efficiency of its operation, so that a greater proportion of its own resources can be used for productive investment;
- A tax scheme that allows the successful development of exploration and exploitation projects in more complex oil fields;
- A more flexible budgetary scheme would permit improvements in the daily operation of Pemex, in maintenance and in operative reliability; and,
- In any case, it is necessary to have a transition regime in which the rhythm of tax and budgetary adjustment is associated with the correction of the operative disequilibrium of the company and the strengthening of the national public finances.

III. OIL PROFITS

There are different factors that threaten the continuity of oil profits, among which are the increase in the costs of extraction, and the risk that the production platform cannot be sustained if the changes that would permit Pemex to multiply its execution capacity do not materialize.

Therefore, energy policy must be oriented towards maximizing the value of oil profits in the long term, addressing the factors that determine it. In this regard, it is advisable to implant policies that permit the expansion or maintaining of the production platform and keep the costs as low as possible. It is necessary to strengthen the capacity of the State as regulator of the exploitation of the natural resource, which is to say of hydrocarbons.

IV. OPERATIVE FRAMEWORK OF PEMEX

The legal scheme for contracting public works and acquisitions is inadequate for the needs of the oil industry and prevents the development of long term relationships with suppliers and contractors. Thus a new regulatory framework is necessary for Pemex, which grants it flexibility in basic aspects of its management, without affecting the leadership of the State in relation to hydrocarbons. This should permit:

- Adequate forms and procedures for the contracting of investments, goods and related services; and
- An agile exercise of the contracting of engineering, procurement and construction of projects.

It is also necessary to promote a substantial improvement in the corporate governance of Pemex, consistent with greater management autonomy, that improves transparency and accountability, without affecting its nature as a company owned and controlled by the state. A new model of control and oversight is necessary, which at the same time as it facilitates operations, strengthens the effectiveness of the efforts to combat corruption.

V. CONCLUSIONS

The document concludes: it is necessary to carry out a revision of the entire regulatory framework of the state oil industry based on the following premises:

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- a) The oil belongs and will continue to belong to Mexicans;
 - b) Strengthening the leadership of the State over its energy resources; and
 - c) Without privatizing Pemex, either its assets or infrastructure.

- The Diagnostic makes the following suggestions:
- Adjust the regulatory framework to which Pemex is subject in order to provide it with agile and modern mechanisms for its operation;
- Grant the company greater management autonomy;
- Ensure operative flexibility;
- Incorporate changes in its corporate governance that provide it with a more appropriate structure and reinforce its mandate of obtaining the greatest revenue possible for the Nation;
- Consolidate Pemex as a company for all Mexicans.

ADMINISTRATIVE LITIGATION PROCEEDINGS

At the present time, resolutions of the Mexican Industrial Property Institute can be impugned by means of Administrative Litigation Proceedings filed before the Federal Tax and Administrative Justice Court.

The manner to challenge these resolutions previously was through an Action for Relief ("Amparo"), which does not in itself represent a plea within the administrative process, but an action on constitutional control.

Now, an Action for Relief is the last resort and therefore, as ordered by the Amparo Law, before being able to access to same, all previous resources must have been exhausted which, in the present case, would be Administrative Litigation Proceedings.

A resource which is incidentally processed is contained within Administrative Litigation Proceedings, as governed by the Federal Administrative Litigation Proceedings Law, through which one can request suspension of the effects of the action impugned so that the original status quo is maintained, thus avoiding the proceedings being left without subject matter. An example of this suspension is when the Federal Consumers Bureau imposes a Federal, not Tax, fine for some infringement and, on impugning the resolution giving rise to said fine through Administrative Litigation Proceedings, it is asked that the Administrative Litigation Proceedings to effect compulsory collection of said fine be suspended, in order that no payment is required and that the goods guaranteeing the payment of same not be seized.

The current Law, in article 28, establishes that a series of requirements must be complied with to grant this suspension, these being:

"The plaintiff can, on complying with the following requirements, request that execution of the administrative action impugned be suspended when the authority involved refuses to suspend same, rejects the guaranty offered or recommences execution,

I. He can request this either in the complaint itself or at any later time before a sentence is returned, before the Chamber hearing the action.

II. Attach copies of the promotion in which suspension is requested and of the documentary proof offered so that each one of

the parties can be summoned, together with an additional copy for the suspension file.

III. To offer, as applicable, documentary proof in connection with the offering of the guaranty, the request for suspension filed before the executing authority and, should such exist, documentation recording the refusal to suspend, rejection of the guaranty or the recommencement of execution, this being the only evidence admissible in the suspension.

IV. To offer a sufficient Guaranty by means of a note of deposit or bonding policy issued by an authorized institution, to repair the damage or indemnify any damages which may be occasioned to the defendant or to third parties by suspension, if no favorable verdict is obtained in the administrative litigation proceedings.

V. The documents mentioned should be issued in favor of the opposing party or of any third parties who may be entitled to repair of the damage or the indemnity mentioned.

VI. With respect to a request for suspended execution against acts in connection with the determination, settlement, execution or Collection of payments or credits of a tax nature, suspension of the act in question will apply and will take effect if a tax interest guaranty has been, or is, established before the executing authority by any means permitted by the applicable tax laws.

The jurisdictional agency is empowered to reduce the amount of the Guaranty in the following cases:

- a) Should the amount of the credits exceeds the economic capacity of the plaintiff, and
- b) In the case of a third party other than the subject, being obliged directly or jointly to pay the credit.

VII. To explain in the document requesting suspended execution of the act impugned, the reasons why it is considered that the measure should be granted, and the harm which would be caused should the acts, the suspension of which is requested, be implemented.

VIII. Suspension will be processed separately and in accor

dance with the provisions of this Chapter.

IX. The Prosecuting Magistrate can decree provisional suspension in the writ resolving on the request for suspended execution of the act impugned, always providing that this does not affect the public interest, contravene provisions of public order or leave the proceedings without cause, or should any of the following apply:

- a) That no acts are involved which have been irreparably consummated.
- b) When greater damage is caused to the plaintiff if suspension is not decreed, and
- c), That clearly show, without examining the matter in depth, the manifest illegality of the administrative act impugned..”

However, these requirements exceed those required under the Amparo Law, as the latter does not require the plaintiff to previously ask the executing authority to suspend the prejudicial action and, should suspension is refused, execution reinitiated or the Guaranty rejected, is able to appear before the Amparo Court to ask that action be suspended.

Nor, on another aspect, is it required that proof be presented with respect to the offering of a Guaranty, the request for suspension filed or, should such exist, documentation evidencing the refusal to suspend, rejection of the Guaranty or the recommencement of execution..

No explanation is required as to why the measure should be granted, or on what damage would be caused by implementing the action.

And, lastly, it is not necessary for the manifest illegality of the administrative act impugned to be obvious.

The Amparo Law states that, in order for an action for relief to be filed, all other resources contained in the Law giving rise to the objected action must be exhausted, since an action for relief is not a recourse but a Petition for Constitutional Control, called a principle of definition and, as an exception to said principle contained in article 73, section XV of said Law and cited a *contrario sensu*, states: “an action for Relief will be in order when, under applicable law, the actions of authorities other than the law, administrative or labor courts are contested, and the effects of said actions can be suspended by

the filing of some recourse or other means of legal defense, when said laws demand requirements for granting suspension in addition to those of the Amparo Law”.

Therefore, and since the foregoing requirements clearly exceed those of the Amparo Law, the Judicial Power of the Federation has, since February 2007, been adopting a criterion, currently Jurisprudence 109/2008, which provides that it is not necessary to resort to Administrative Litigation Proceedings to access an action for Relief when only suspension of the effects of the action impugned is required. We indicate the most relevant part of said jurisprudence below:

“RECOURSE OF REVIEW. IT IS NOT NECESSARY TO EXHAUST THE PROVISIONS OF ARTICLE 83 OF THE FEDERAL ADMINISTRATIVE PROCEDURES LAW BEFORE RESORTING TO AN INDIRECT ACTION FOR RELIEF. According to article 83 of the Federal Administrative Procedures Law, those affected by the acts and resolutions of the administrative authorities or semi-State organizations governed by this ordinance, including the Mexican Industrial Property Institute, which finalize the administrative procedure, a petition, or resolve a file, have the option to impugn these by means of a recourse of review at administrative headquarters or by means of administrative litigation proceedings before the Federal Court for Tax and Administrative Justice; and it is therefore unnecessary to resort to the action for relief mentioned prior to filing constitutional action, since in view of the optional nature of said means of impugnement, it cannot be accorded a mandatory nature it does not possess, especially so if, in fact, an exception is made to the principle of definitivity contained in article 28 of the Federal Administrative Litigation Procedures Law (a legal ordinance which supersedes the Federal Tax Code in Administrative Litigation Proceedings) by demanding more requirements than the Amparo Law in order to suspend the protested action....”