A Mexican Development Fund financed by oil revenues: putting the Guanajuato proposal to work

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GOING BEYOND NAFTA

- Trade and investment have nearly tripled a decade after **NAFTA** came into effect.

- In Guanajuato, Presidents Fox and Bush talked about
  - Developing "a North American approach to the important issue of energy resources"; and
  - Striving to "consolidate a North American economic community whose benefits reach the lesser-developed areas of the region and extend to the most vulnerable social groups in our countries".

THE UNITED STATES GROWING NEED FOR IMPORTED OIL

- Over the next decade, the excess demand for oil in the United States will reach 3.6 million barrels a day.
- Canada is expected to increase its production by 600,000 bd .
- This creates a market opportunity for 3.0 million bd.
- Mexico has a grade of oil difficult to compete with, neither light nor heavy, "*reliable crude*", contributing to North American energy security
- As it is, Mexican crude oil exports to the U.S. have increased by two thirds since **NAFTA.**

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MEXICO NEEDS TO INVEST TO GROW

- Mexico's growth performance is unsatisfactory. Potential **GDP** growth is constrained by
  - Inadequate physical infrastructure,
  - Inflexible labor markets,
  - Burdensome and uncertain regulatory and judicial environment that weaken investment incentives
  - Low levels of human capital,
  - High industrial energy prices
- The needed investment in human and physical capital is constrained by weak government revenues.

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LEVERAGING MEXICO'S OIL RESERVES TO SPUR GROWTH

- A two-step strategy
  - energy investment fund to finance an increase in Mexico's production of crude
  - use the resulting revenues to carry out social investments in human and physical capital to increase productivity

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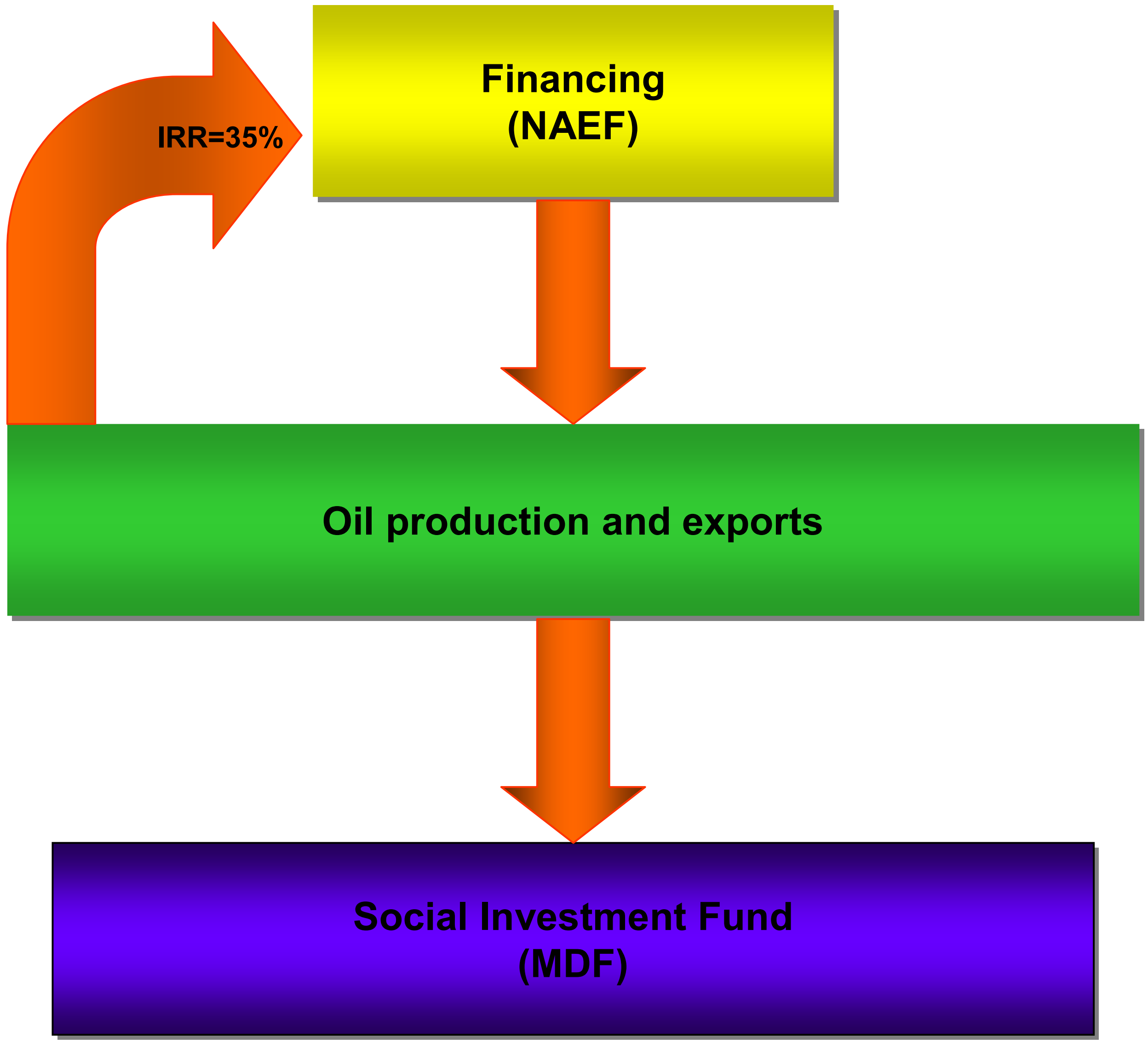

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IMPERATIVES

- Consistent with the Mexican political compact and the Constitution. Making it contingent upon changes in the current legal framework will guarantee its failure;
- Independent control system so that funds are dispensed in a manner that is transparent and exempt from conflicts of interest. Best practices with respect to governance;
- Effective.

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RESOURCE BASE

- Mexico has the largest conventional proved crude oil reserves in North America;
- Little investment in exploration and development during 1990-2001. Reserves decreased 20% between 1990 and 2003;
- Spending in exploration has increased to almost 2 billion dollars for each of the last two years:
  - Exploratory wells have increased 40%,
  - Development wells 90% and
  - 38 new fields have been discovered.
  - **PEMEX** is now replacing 75% of the reserves it uses.

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PRODUCTION

- 2003 oil production 3.4 million barrels a day; fourth largest in the world.
- 2003 gas production 4.4 Bcfd;
- Proven plus probable reserves sufficient to maintain current oil production during 22 years and current natural gas production during 28 years;
- Norway, Canada, or the United States maintain about 10 years worth of reserves.
- Exports of 1.8 million barrels a day of crude oil
- Imports of 750 mmcfd of natural gas.

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THE CASTAÑEDA PROPOSAL

- Doubling oil exports by 2010 and becoming a marginal exporter of natural gas
- Strengths North American energy security.
- Provides 10 billion dollars of additional government revenues.
- Current reserves would sustain 14 years of production, above international standards.
- 15 billion dollars of financing per year for the rest of the decade are required.

SOURCES OF FINANCING

- Mexico **will have to lead** by example:
  - Congress will have to increase its appropriations for **PEMEX**’s investment in exploration and production 50% above its current levels;
  - Additional funds can be raised through the Bolsa Mexicana de Valores.
- If **PIDIREGAS** and **CSM** continue to flow at the rate of 7 to 8 billion dollars a year that leaves 3 to 5 billion dollars a year to be financed by the **NAEF**.

FINANCING NAEF

No magic bullet; lots of hard work for PEMEX and the Secretary of the Treasury :

- Governments: **NAFTA** signatories as well as other countries
- Multilateral financial institutions (IDB, World Bank, etc…)
- Private sector.

PEMEX
TRADITION AND CHANGE

- None but **PEMEX** can carry out this project
- Different corporate culture has to be put into place with total transparency and accountability.
- Political consensus in Mexico on the importance of this project and on the fact that transparency and supervision in the disbursement of funds are indispensable.

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PROJECT PROFITABILITY

- 80% percent of flowing oil can be produced at a cost of under US$5/barrel: half operating costs; half capital costs;
- Pretax rates of return vary from 26% to 70%, significantly above the 15% threshold usually required to justify such investments.
- Profitability is more than adequate to attract private financing.

NAEF's SOURCES

Five options:

1. Leases for large ticket items;
2. Special facilities at the US and Canada Import/Export banks for loans, insurance and guarantees;
3. Institutional investors in the United States and Canada or pension funds;
4. IDB and World Bank have been unwilling to commit to this sector except as part of a liberalization process. But things may be changing.
5. Purchase program for the US Strategic Reserve

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RISKS

- One way or another **PEMEX**'s debt will increase
- Important to maintain it credit rating
- The oil sector is de facto dollar denominated
- Many **PEMEX** contracts acknowledge the authority of US courts –typically New York, thereby decreasing contractual/judicial risk.
- Design and execution risk
  - backlog of energy project
  - audit/certify them by experts (IDB, WB)

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RISKS

- **Main** obstacle is the lack of a social compact about the Mexican energy sector.
- Lack of coherent long-term hydrocarbon strategy has weakened the sector. The energy and petrochemical sectors have decreased their competitiveness.
- Energy prices are higher than those that would prevail in a competitive environment
- Instead of focusing on how to insure that **PEMEX**'s and **CFE**'s reach high levels of productivity, ideological confrontations about privatization.

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THE SOCIAL INVESTMENT FUND

- If additional revenues are an excuse for subsidies and low productivity, repeat of 1982 debt crisis
- Investment in social human and physical capital
- Combating poverty
- Structural reforms have to be carried out
- Prudence and accountability:
  - Macroeconomic stability
  - Decreasing special fiscal privileges
  - Increasing non-oil revenues
  - Labor sector reform to increase flexibility
  - Reform of justice system
  - Deregulation

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THE SOCIAL INVESTMENT FUND

- Ten billion dollars a year will not solve all these problems at once but they can go a long way
  - doubling expenditures in science and technology,
  - increasing by a half spending in justice and law enforcement **AND**
  - increasing investment in health and education 25%.

- The strategy offers an opportunity to significantly increase total factor productivity and long run growth perspectives.

CAUTIOUS OPTIMISM

- During the Tequila Crisis, the international financial community helped Mexico's at the tune of 50 billions dollars
  - **because** the Mexican government convinced the international community it would make prudent use of those resources and
  - **because** it accepted that its disbursement could be closely supervised.

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CAUTIOUS OPTIMISM

- Private investment in the Mexican energy sector since the timid liberalization of 1993-1996:
  - 13 gas pipelines crisscross the U.S.-Mexico border with a total capacity of 2.5 Billion cubic feet a day (Bcfd);
  - New power plants have been built in Baja California to supply electricity to Southern California;
  - Private companies own more than 1,000 Km of pipelines and 50 million horse power of compression capacity;
  - Local distribution companies have invested a billion dollars to serve 2.4 million homes in twenty cities;
  - Five newly devised Contratos de Servicios Múltiples worth 4.4 billion dollars have been granted to four consortia to explore and develop dry gas fields in the Burgos basin. Total new production is expected to reach 440 million cubic feet a day (mmcfd); and
  - **PIDIREGAS**, have become the main source of financing of capital expenditures and totaled 24 billion dollars in 2002.

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CONCLUSION

- Drivers:
  - Strengthening North American energy security
  - Leveraging Mexico's oil resources to spur growth
- Characteristics
  - Political pragmatism; **NO** change in regulatory framework
  - Support from **NAFTA** partners
  - Two step strategy
  - Mexican effort
  - Transparency and accountability

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