



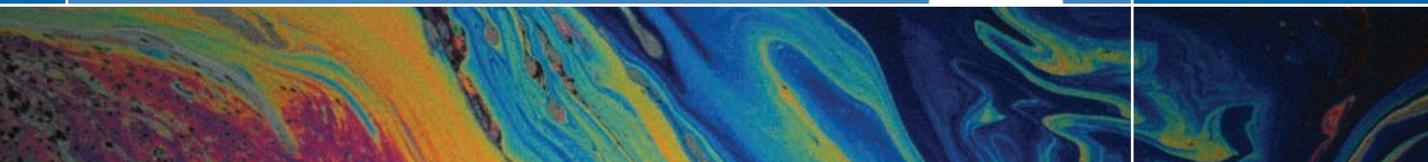
Woodrow Wilson  
International  
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*Mexico Institute*



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**Perspectives from**  
LUIS DE LA CALLE  
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2007

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Available from the Latin American Program and Mexico Institute

Woodrow Wilson International Center for Scholars  
One Woodrow Wilson Plaza  
1300 Pennsylvania Avenue NW  
Washington, DC 20004-3027

[www.wilsoncenter.org/mexico](http://www.wilsoncenter.org/mexico)

ISBN 1-933549-28-9

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## Foreword

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This volume is the product of a seminar that was held at the Woodrow Wilson Center in Washington on July 13. Although Mexico's energy policies are important to the United States in a variety of ways—which is why we held this meeting in Washington—the public and political debate surrounding these policies are for the Mexican people and their representatives alone. My sense is that recommendations coming from their energy hungry neighbor to the north only complicate an already complicated situation.

It is clear that Mexico's geographic and historic relationships with the United States have shaped, to some degree, their current energy policy. No one who has seen the films of Mexicans—rich and poor—lining up in the Zócalo to contribute whatever they could to pay for the nationalization of the oil industry in 1938, can doubt the strong emotional tenor of the discussions to come.

Mexico's proximity to the United States has created a kind of gravitational policy warp. I have argued that if you took Mexico and its 120 million people and moved it to Southeast Asia or to Africa, their energy policies would look much like those of their new neighbors. Conversely, move South Africa to our southern border and you might see a very different energy regime than is currently being administered in Pretoria—perhaps something more like Mexico.

Finally, although in some ways the debate in Mexico seems to break down into ideological camps, it is really more complicated than that. I know someone who, while working at the Secretaría de Energia (Energy Department) in a former administration, took Mexican Congressmen on fact-finding missions to Cuba. While there, he would remind them that in energy reform they need do no more for Mexico than what that wily old capitalist Fidel Castro had done for Cuba.

We are pleased to present these reflections from three distinguished analysts on the state of the energy debate in Mexico and possible directions for the future.

Roger W. Wallace



# Saving Pemex or a New Energy Policy in Mexico?

Luis de la Calle

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Oil is a very sensitive issue. It is so for Mexico, and it has been as sensitive in the bilateral relationship as it was during the NAFTA negotiations. It was also very sensitive in the context of the migration debate a few years ago. At that time I wrote an op-ed suggesting that Mexico should move ahead with the energy reforms regardless of the migration bill, but that linking migration with oil was an opportunity for Mexico to discuss the energy issue. Today, the good news is that there is still some oil to put on the table, but the bad news is that Mexicans have failed to decide what how to manage this precious resource.

I would place the questions that Mexico faces regarding its energy policy in the context of whether or not Mexico believes development can be reached in a generation. It is very clear what development means: becoming a developed country in the complete sense of the word in a relatively short span of time. This is an important question because the reforms Mexico needs to undertake to reach development—and a sound energy policy—in the next 20–25 years are of such a magnitude and so costly that they will not be achieved unless Mexicans are convinced that development is at hand. There is no reason why Mexico would invest in its own development if development is deemed impossible.

Most politicians and analysts in Mexico seem to think that development is impossible, and thus that investing in this project is not a profitable proposition. This belief blunts Mexico's potential for reform and development. The first step in enacting reforms is thus to convince Mexicans that their country can become developed in the next 25 years. If Mexico is reformed—and a great many reforms are still pending—then it will be on its way of becoming a developed nation.

Beyond this change in attitude, Mexico needs to tackle problems with four groups and corporatists structures in order to implement the needed reforms (this set of problems is not unique to Mexico, of course). The first one of these groups is the teacher's union followed by nurses and doctors, energy workers, which include Pemex, CFE and Luz y Fuerza, and finally government employees. The government has already made significant progress by reforming the pension system for public employees in the last few months, but a lot of work remains to be done with other unions.

The structural and pension reforms are generally discussed as separate issues. Mexicans believe they need the structural reforms in the energy sector, on the fiscal side, and then they need to solve the pension problem. However, there is only one reform that needs to be done: one that includes both the pension reform and the structural energy reform.

The irony is that the people that need the pension reforms the most are the ones that oppose the structural reforms. The resistance comes basically from the energy unions, the entity that needs the reforms to pay for their pensions. While the managing director and the former managing directors of Pemex are very important people, they do not have the power of the Mexican Congress, which is granted under the Mexican Constitution the sole power to issue public debt. In this manner, pension's liabilities for union employees in Pemex and CFE are not public debt. Thus, if Pemex went bankrupt (no longer impossible), current and future retirees would receive

no pension. Pemex does not own the reserves, which means it has few assets, and therefore it does not have enough resources to pay those pensions.

At the beginning of President Vicente Fox's term he made a significant mistake when he met with the union of Mexico's City power company, the most radical in the country. None of the members of this union had voted for him. It was thus mind-boggling that President Fox would risk going to that meeting. To make matters worse, he assured the union that his administration would not privatize the power company, thus wasting a valuable bargaining chip the very first day he met them. The transition from the long running PRI governments to an opposition government headed by the PAN represented an opportunity to point out to public sector unions that their pensions were not properly funded and, therefore, that a commission to seek ways of funding those pensions would be established. This is an opportunity that President Fox chose to miss.

In fact, Mexico needs an intergenerational agreement with the unions. The average age of a Pemex worker is 55, which makes them relatively old compared to the national average and yet their pensions are not funded. An inter-generational agreement could be negotiated as follows: the pensions of these workers will be funded in exchange for energy reforms. Older workers would allow reforms to happen so that younger generations would be more productive and thus able to afford the pensions. As part of the agreement the pensions, though less generous, would be guaranteed.

There are two approaches to the energy reform, in my view. One is to have a sound energy policy. The other one is to save Pemex. Unfortunately, authorities in Mexico are only considering the second one. Saving Pemex has become the main objective of Mexico's energy reform. I remember when I was living in Washington that a very interesting book was published called "How to Milk the US Government." In Mexico, we could have an encyclopedia on "How to Milk Pemex." Of course, a lot of people want to save Pemex. They want to save it, in order to continue milking it for all its worth.

On March 18, 2007, during the celebration of Mexico's expropriation of the oil sector, President Felipe Calderón said that he would base his energy policy on seven pillars: exploration, technology, financing, transformation (petrochemicals and refining, that is), transparency, and efficiency. You might wonder if there is a missing component in the pillars. There is no mention of competition, of course. He is proposing everything to save Pemex, but apparently competition is not something that the government seems to be thinking about. In my opinion, this is a great mistake.

First let's take a look at how to save Pemex and then I will discuss my own proposal regarding how to establish an energy policy.

Pemex's objective according to Mexican law and under the Constitution is to strategically manage the activities related to the oil industry, yet there is no clear understanding of what "strategically" means. In contrast, if you look at the webpage of say Exxon or Shell, or other oil companies, their mission statements do not include "a strategic management of reserves." Exxon's mission statement sets the goal of becoming the premiere oil and petrochemical company in the world.

Saving Pemex is very much tied to the fiscal reform, which is now being discussed in the Mexican Congress. Pemex's director claims that it needs an increased budget of some \$10 billion dollars a year to be able to operate and explore for more oil. This would include an increase in the exploration budget of \$2 billion dollars per year, to reach a 70 percent replacement rate. The problem with this analysis is that Pemex's budget for exploration was sharply increased during Fox's term, and the replacement rate remains low, although in 2006, it reached at rate of 41%, up from rates in the mid-teens. The question is, why is exploration not yielding more oil?

There are several reasons. One is that the more accessible wells have already been found, and it is now more difficult than it was in the past to find massive new reserves. Or, maybe Pemex's exploration and exploitation unit is not as efficient as we think. Maybe there is no oil. Or, as Jesús Reyes Heróles claims, if you have budgets that are unpredictable—one year you have funds, and the next year they are taken away—it is difficult for Pemex to explore efficiently. There is a whole discussion as to whether putting more money into exploration is a wise investment decision or not and it should be tackled before learning whether saving Pemex is worth it. The most worrisome fact is that we really do not know what Pemex's potential really is.

A second issue related to saving Pemex is the collective bargaining agreement, which is negotiated every two years. The agreement will be reviewed in September 2007 and subsequently renegotiated in 2009 and 2011. It is a very political issue. Thus, if one were in the government's shoes, would you negotiate in 2007 or in 2009? One might say that negotiating in 2007 makes sense in the context of the fiscal reform which is going on right now through the Mexican Congress, while 2009 is an election year, and 2011 is just before the presidential election. Now, if we negotiate the collective bargaining agreement with Pemex in 2007, with Mexico giving more money to Pemex to pay for those pensions, without the reforms, the remaining bargaining chip with the union in terms of our energy reforms might be lost again.<sup>1</sup>

If money is given to Pemex with no concessions in exchange, there might be no reform. Pemex also has a perverse incentive, which comes out of the differential rates of return on crude oil as compared to gas or petrochemicals. If oil is found and produced at \$4 per barrel and sold at \$60, it provides a nice return or rent. Part of the problem with Mexico is we have become, throughout our history, a country of rent-seekers.

In the 18th century Mexico built the Mining Palace, a beautiful building in downtown Mexico City. In the 20th century Pemex's tower was built, as a monument to rents; one produces at \$4, and he sells at \$60. Mexico always claims that it is a very old country, but the bicentennial is in 2010, only 33 years after the United States, which is perceived as a young country. Mexico is turning 200 years old in 2010.

For the previous ceremony, 100 years ago, an archangel was built as a monument to celebrate independence. Mexico did not choose a founding father like Hidalgo to build the monument, rather a non-controversial figure: an archangel. What is going to be chosen for 2010 as a

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1. As it turns out, the collective bargaining agreement was renegotiated in September with the union agreeing to no concessions to speak of.

monument? In my opinion, a monument should be made to the Mexican citizen, as a gamble, if you wish, in favor of development, rather than more monuments for rentists, or rentism.

The problem that Pemex has is that investing in gas, in petrochemicals, is less palatable in terms of the differential rates of return than investing in crude oil. Thus there is not enough investment in gas or refining. Not only that, the irony is that if you ask Pemex's director whether Pemex makes any money on refining in Mexico he will tell you, "No, every refinery in Mexico loses money." "How much money do you make in your Deer Park joint venture with Shell in Texas?" "A billion dollars a year." Then he proposes in his budget to build refineries in Mexico, as opposed to building one more refinery in the United States, where there is no collective labor agreement, another restriction that makes those refining facilities unprofitable.

A controversial discussion in Mexico on gas stations took place last year. The question was, why would gas stations steal from consumers by selling liters that are less than a liter? Why would gas stations not accept credit cards as a means of payment? The conclusion that most politicians arrived at was to strengthen the Federal Consumer Protection Agency to protect consumers against gas stations. But nobody proposed the obvious: let's inject competition into gas stations. If there were Shell, Citgo, Texaco and Exxon stations in front of Pemex, would those gas stations steal gas from their customers? Of course not. Do you think they would accept credit cards? Of course they would. Nobody thought that introducing competition into the system was the solution to the gas station problem that we have in Mexico.

What is my suggestion for energy policy reform? The first item in my proposal is that ideology plays a role, but not a dominant role in the debate. The dominant role in the debate is played, rather, by interest groups. There are a lot of people that participate in the milking of Pemex, including the government, of course, and who have no incentive to change the status quo. Until these groups' economic interests are taken into account, reforms will not happen. That's why linking the structural reforms to the pension reforms is so important; it internalizes one of the large benefits that are derived from the Pemex operation, which is the pampered workers in that sector.

The second point is: do not start the discussion with the constitutional reforms. Every discussion on energy begins saying, "Mexico needs to reform Article 27 and 28 of the constitution." That is a nonstarter, because to change the constitution a two-thirds majority is needed. Why insist on the impossible? I would rather we think it along the following lines: most people think NAFTA is a preferential agreement. It is not. Mexico does not give preferences to the United States, since it has an agreement with the European Union, with most of Latin America and with Japan—where is the preference for the United States?

NAFTA is not a preferential agreement for Mexico any more. The United States has an average import duty on industrial goods of two percent and agreements with many countries in the world and would have a lot more if the administration had more convincing arguments with Congress. The end of the preferential agreements calls for Mexico to have very low import duties itself, on a Most Favored Nation (MFN) basis.

When one proposes to industrialists in Mexico that most favored nation import duties be lowered on industrial goods, they tell him, "We can't, because we have inefficient energy, which is very expensive and makes us less competitive." Well, the answer is, "Listen. I'm going to open

the economy, for all sectors, but particularly for the energy sector.” NAFTA lowered duties on everything, but did not remove all obstacles. Significant obstacles remain for the trading of energy products. My proposal is, why don’t we have free trade in energy products? By “free trade,” I mean international and domestic trade. No obstacles for imports or exports of all energy products; crude, gasoline, basic petrochemicals, electricity, gas, and all derivatives, and no restrictions for trading of those commodities domestically, either. There is no constitutional mandate to prohibit open trading in all energy goods in Mexico, with the exception of electrical power, which can be done only by government-owned companies.

But there is a lot of room, even in electricity, to have fully open trade in energy products. It would transform Mexico’s energy market. It would transform Pemex, and it would be an energy policy. Pemex is now concerned because it has to invest \$5 billion in a new refinery and because of a potential shortfall of gasoline in Mexico. Why don’t we let private companies worry about whether they can deliver gasoline to the Mexican market by opening imports and selling gasoline in Mexico to everybody? The Constitution says that a strategic sector like oil will be a government monopoly. It does not say there should be a monopoly on the selling or trading of energy goods. Thus, Mexico could control its own reserves, as it should, because there is rent that belongs to all Mexicans, while opening entirely the trading of energy products to competition.

The objective of the energy policy is to create a market which does not exist today, where free transactions will ensure quality, prices, and supply of all energy products, and would free, significantly, resources that Pemex could use for oil purposes. That would imply a complete opening of investment and trading for gas, natural gas, and petrochemicals. It requires changes only to federal law and no changes to the constitution. This is something that is relatively easy to do and is a debate that I think can be won in Mexico. Instead of focusing on “saving” Pemex or allowing foreign investment in our national reserves, let’s move forward with what open trade has done for the rest of the economy, which is make it competitive by opening the whole energy sector to free trade. U.S. collaboration would be needed to do the pipelines so that significant trade can happen and also to lay the power lines at a sufficient height so that if a wall is built, the electricity can continue to flow.

I have identified all the changes that need to be made to Mexican law to allow free trade on energy product and there are no many. By establishing free trade in energy products and promoting competition in the Mexican market, supply would be ensured along with quality, but most importantly, the assets that belong to Mexicans will be put to their best use and we maximize the value of Mexico existing reserves.

According to President Calderon, there are 9.3 years left of oil reserves. Most people consider it a disaster because they were always told that we had 60 years. In fact, 9.3 years is close to the average most oil companies have. Of course, the difference is that most oil companies have replacement ratios that are higher than Pemex’s today.

I believe that Mexico should emphasize changing the nature of the debate, and betting on the side of letting the markets work. Injecting competition into the energy market is the right way to go, as it allows us to frame the debate in a way that is not based on ideology, but rather on our mutual interest, and places Mexico’s national interests where they should be.



# Mexico's Oil: Who needs it?

José Luis Alberro

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I want to frame the nature of Mexico's energy conundrum with the question, "Who Needs Mexico's Oil?" and highlight four concerns:

- First, we must ascertain the probability that Mexico's reserves and production will continue to decline;
- Second, lest one is willing to assume that pouring money into exploration and production will reverse such a trend, it is important to assess PEMEX's execution capabilities since it has not yet shown that it can invest in exploration and production in an efficient and transparent manner;
- Third, Mexico's transition to democracy is on a slow take-off. The current political climate is fraught with fears, rancor, and cries to settle old scores. A reformist agenda in the energy sector is unlikely to prosper, the shortcomings of the current legal/regulatory regime notwithstanding;
- Lastly, companies which do need Mexico's oil should plan strategically, take the initiative, and propose ways to structure their relationship with PEMEX around the notion of contracts with performance clauses as explicitly put forward in the North American Free Trade Agreement.

The first answer to my core question, which is also the title of this paper, is that the avid U.S. consumer does need oil and that Mexico is one of the leading suppliers of oil to the United States. This fact is present in Mexico's reality and is often used to justify why Mexico should never relinquish control of its oil.

How much Mexico needs its oil for economic development is debatable. If Mexico were no longer perceived as asset-rich, would that be a hindrance to its growth? Actually, it would not. Stumbling upon another Cantarell<sup>2</sup> would postpone the structural changes required to access long term sustainable development, the same way it has done so for the past 25 years. Modern growth theory has established that factor accumulation—and its financing—is, at best, a minor driver of growth.<sup>3</sup> What Mexico does need is to change its institutions to increase total factor productivity: rule of law, political and electoral reform, flexible labor laws and an aggressive competition policy, especially in the energy sector.<sup>4</sup>

The fact that Cantarell's production is declining, that PEMEX is not replacing 100% of its reserves and that policy debates focus on sovereignty and not on PEMEX's lack of performance or transparency is a measure of the prevailing myths. Current discussions center on the tradeoffs between privatization and sovereignty or between the federal government's reliance on oil

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2. Cantarell is Mexico's largest oil field. It was discovered in 1976 and by 1981 it was producing 1.2 million barrels per day (MMbd). Production dropped to 1.0 MMbd in 1995. PEMEX then took a strategic decision to inject nitrogen into the field to boost production in the short run at the cost of significantly shortening its useful life and total yield. No one has claimed responsibility for such a disastrous decision. As a result, production increased to 1.6 MMbd in 2000, 1.9 MMbd in 2002 and 2.1 MMbd in 2003. It has been declining since 2004.

3. Robert E. Lucas Jr., *Lectures on Economic Growth*, Harvard University Press, 2002. William Easterly and Ross Levine "It's Not Factor Accumulation: Stylized Facts and Growth Models," *World Bank Economic Review*, Volume 15, Number 2, 2001.

4. Douglass C. North, *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, 1990.

revenues and the need to use them to modernize PEMEX, instead of acknowledging that further structural changes are necessary for growth to resume and preparing to mitigate the accompanying social and economic dislocations.

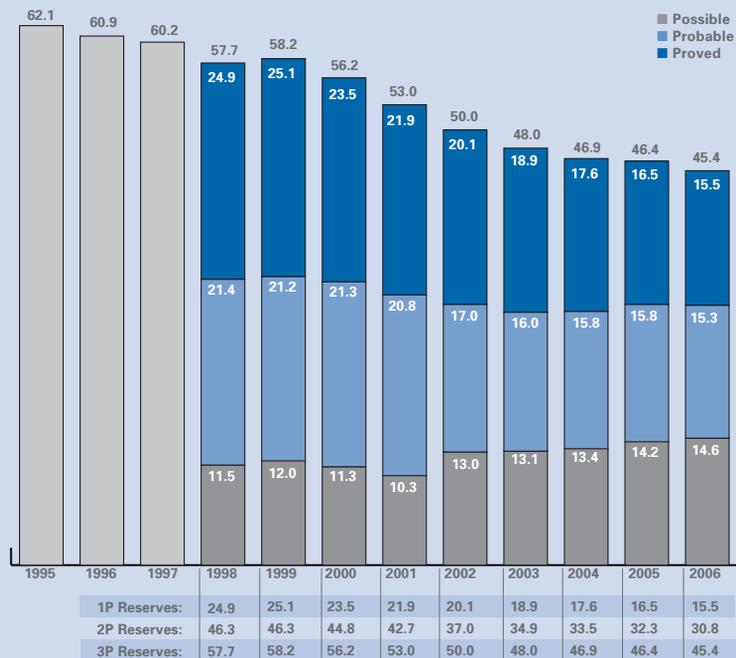
## Mexican Oil's Disappearing Act?

Since 1995, proved reserves (P90)<sup>5</sup> have been halved; at current production rates, they will only last 9 years. While proved plus probable (P50) plus possible reserves (P10)<sup>6</sup> could last three times more (28 years), they too have been decreasing reflecting the fact that, for decades, there was little investment in exploration. The Fox administration (2000–2006) reversed that scandalous policy, causing possible (P10) reserves to increase by almost 40% since 2001.

Estimating the size of the oil resource base remains elusive, though, because while in the United States most of the territory that could yield oil has already been explored, that is not the case in Mexico where no more than 20% of the territory has been surveyed. The lore among PEMEX's retired exploration engineers is that there is a lot of oil to be found.

### EVOLUTION OF RESERVES

Billion barrels of crude oil equivalent



Source: Pemex

5. Those that have a 90 percent probability of yielding that amount of oil.

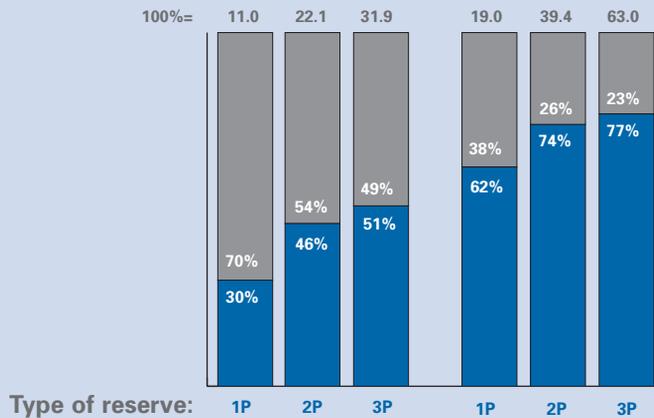
6. Those that have a 50% and a 10% probability of yielding that amount of oil.

GEOGRAPHICAL DISTRIBUTION OF RESERVES



Reserves as of December 31, 2006:

CRUDE RESERVES (MMMB) NATURAL GAS RESERVES (Tcf)



Source: Pemex

Note: Numbers may not total due to rounding

■ Off-shore  
■ On-shore

It should be noted though, that production costs are expected to more than double between 2008 and 2012 and that the most important unexplored areas are in the deep waters of the Gulf of Mexico. As a result, the proportion of offshore reserves decreases as you go from 1P to 3P for both oil and gas. The exploitation of those deep waters reserves requires technology that PEMEX cannot currently access. Whether those reserves can be explored and exploited without “risk contracts” which are forbidden by the legal framework remains to be seen. Cuba and North Korea have joint-ventured with oil exploration companies to co-develop reserves. Mexico, ironically,

has not been willing to do that yet. Neither the authorities nor the oil companies have been able to design contracts they could live with and that are compatible with the legal framework.

## Pemex's Performance

PEMEX's performance over the last decade has been unimpressive: oil production has fallen; refinery production has been stagnant, despite significant investment in new capacity; and petrochemical production has decreased by 40 percent. The number of employees, though, has increased more than 30% and pension fund liabilities are choking the company.

Let us consider three scenarios for the future of Mexico's oil. In scenario number one, there are no significant oil discoveries, no change in the attitudes of international oil companies, and no change in PEMEX's performance and in the legal framework. Proven reserves will decrease by another half over the next decade and production will decrease *pari passu*. Mexico could still be self-reliant and produce enough oil to cover local needs but exports would grind to a halt, pushing the United States further into the arms of the Venezuelas and the Nigerias of the world. For Mexico, the collapse would cause fiscal imbalances because about one-fifth of government revenues come from oil.<sup>7</sup> Such a shock in the export sector would probably cause GDP growth to slow down, employment to decrease and inflation to increase.

The second scenario is the Virgin of Guadalupe scenario. New reserves are found even though the legal framework does not change, and PEMEX increases production and exports to the US. Little else changes: by 2015 PEMEX has 200,000 workers, waste goes unabated and a growing share of revenues is transferred to retired workers and to "seepages" from the system. There would be no macroeconomic instability and GDP growth would continue at current rates. A miracle such as stumbling upon another Cantarell, would be needed just to stay on track, and we can expect zero real *per capita* GDP growth.

In the third scenario, the political transition accelerates and a new political compact takes place. PEMEX's monopoly on the industrial transformation of hydrocarbons and on the marketing of the resulting products is broken, and there is private investment in refining and extraction of liquids and sulfur. The price of gasoline is freed from its current controls and non-PEMEX gas stations are authorized. Liabilities on the balance sheets of PEMEX's subsidiaries cease to be sovereign risk; in case of financial difficulties the subsidiaries will have to sell underperforming assets or contemplate bankruptcy like any other firm. Private investment in exploration, production, refining and basic petrochemicals is permitted. The first impact of such a change would be to increase government's general fund revenues as yearly losses at PEMEX Refining and PEMEX Petrochemicals have been estimated at several billion dollars and are met by injections of government funds. In this scenario, the Mexican government is assumed to retain ownership of oil reserves and that a legal/regulatory structure is created to sanction its exploitation by private firms as well as by PEMEX as in the cases of Norway, Canada, or other democracies with a large

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7. Indirect taxes collected on hydrocarbons energy are not part of energy sector taxes since they are levied independently of the origin of the good. About one third of gasoline consumption is imported and pays taxes like domestically produced gasoline.

resource base.<sup>8</sup> PEMEX Exploration and Production would continue to be government owned but would have to compete against privately owned companies.

The interplay of these scenarios is the object of speculation. Some believe that the current situation could morph into the Virgin of Guadalupe scenario if the tax burden placed on PEMEX were decreased. This “effortless” option takes for granted that PEMEX can transform itself into an efficient value-creating enterprise at the same pace that the new resources start flowing in. PEMEX’s standards of accountability and transparency will have to be strengthened for this to occur. Others are resigned to the perspectives that a major reform or the regulatory framework is required and unattainable unless production decreases first (as in the first scenario) thus softening the resistances to the break-up of PEMEX’s monopolies.

The Mexican economy took almost two decades to globalize but, except for the manner in which elections are carried out, little has changed in the political arena. Mexico has been in political gridlock for a decade under the combined forces of powerful rent-seekers, political institutions designed for a one party rule that are dysfunctional in a presidential system in which three parties receive about one third of the vote and a political ethos burdened by a populist past: retribution for past injustices is the highest priority; change only requires the sacrifice of others; and compromise is bad.

The 1938 nationalization of oil facilities is at the core of the foundational myths of modern Mexico because it combines modernism (oil exploitation and transformation is intimately connected to engineering and thus science), the revindication of sovereignty against the nascent empire, and access to a source of energy that was and has been crucial for economic growth. But Mexico has always had a tortured relationship with its oil, knowing the greed of its powerful neighbors. As the poem “Suave Patria” by Ramón López Velarde says:

*El Niño Dios te escrituró un establo  
y los veneros del petróleo el diablo.*

.....

*Patria: un mutilado territorio  
se viste de percal y de abalorio<sup>9</sup>*

Transcending the mercantilist and rural undertones of Mexico’s imaginary in the XXI century is a traumatic experience and oil is the last refuge of lost illusions. Facing the demands of a global world and acknowledging that 70 years after the heroic gesture Lilliputian interests have subdued the giant PEMEX is a tall order for a political world that has not yet shed the training wheels

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8. Government owned oil companies that do not compete with privately owned ones seem to be inconsistent with the requirements of transparency and the rule of law of modern democracies. Dictatorships—as in Venezuela or Saudi Arabia—seem to offer a fertile ground for the opaque environment they require.

9. God-The-Child deeded you a stable  
and gushing oil was the gift of the devil.....  
Patria: percale and beads  
clothe your mutilated territory

of a compact led by caudillos that sometimes act like warlords. Rent-seeking is profitable in the oil industry. Billions of dollars can continue to be had as long as the sector continues to be exclusively in the government's hands.

Reformist political agendas have little probability of being successful because political regulations were drawn up years ago to insure the persistence of the existing parties and it is in the interest of none of them to stop such rent seeking activities. Rather than a break up of the existing political machinery, what the 2000 election of Vicente Fox to the presidency entailed was the PAN replacing the PRI with no structural change. The rest is unchanged: the interests of a few continue to prevail over the interests of the majority.

Opening up has also been hampered by the fact that the virtues of globalization are unclear. The inability to ease the pains of the losers of globalization augmented by the seemingly endless poverty feeds the nationalistic/populist/caudillista political tradition that is alive and well in Latin America: it is not too difficult to argue that the poor are many, the rich are few and in top of it foreigners want to rip-off oil, which is to say wealth. Indeed three resource-rich countries in Latin America have fallen prey to their back-to-the-future populist demons. The bases for a political compact that would bring the needed liberalization of the sector are narrow. Navigating between the Charybdis of increasing competition in the oil sector<sup>10</sup> and the Scylla of assuaging concerns about sovereignty will take a master pilot. Given the passage of recent electoral and fiscal reforms, President Calderón could be that pilot.

Finally it should be recognized that Latin America has not been a priority of U.S. diplomacy during the Bush presidencies. The United States has little goodwill capital that can be leveraged to encourage liberalization.

In the current environment it may be that governments are not the ideal agents for change. If governments are not, maybe private investors ought to be the agents of change.

## The Private Sector Could Lead Change

As an example of how these factors may combine to create a challenging situation, consider the Gulf of Mexico's Western Gap—the “doughnut hole”—where there may be significant reserves of oil and gas. Ten years ago, when the possibility first arose, neither Mexico nor the United States knew how to approach the issue. The United States wanted to promote exploration of the area but Mexico had neither the financial nor technical wherewithal nor the political clarity on what to do. So, in 2000, they signed a treaty establishing an area where there would be a moratorium on exploration and production for ten years.<sup>11</sup> The end to that moratorium is coming up in 2010.

In 2006, Chevron, discovered oil and gas under more than 7000 feet of water. The estimates suggest reserves of 3–20 billion barrels of oil and 6–45 trillion cubic feet of gas. These reserves are

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10. Surveys show that 75% of Mexican would love to see gas stations different from PEMEX's dispensing gasoline. In that concrete case, the costs of a corruption are concrete and daily leading people to question the status quo. In other cases it is much more ambiguous.

11. *Treaty between the Government of the United States of America and the Government of the United Mexican States on the Delimitation of the Continental Shelf in the Western Gulf of Mexico beyond 200 Nautical Miles.*

significant particularly at current oil prices. The deep waters of the Gulf of Mexico may be the last prolific oil frontier in the world.

There are some major transboundary issues, though, because indications are that given the flow dynamics of the fields, the resources on Mexico's side could be affected if drilling occurs on the US side, even if directional drilling is not used. The unitization of fields is not an uncommon issue in the United States and in the world from both the technical and the legal standpoint but Mexico's legal and political limitations may constitute a serious challenge. Could this be an opportunity to craft an agreement between oil companies and PEMEX? Given the need to access more resources, oil companies should try to craft "service contracts" with "performance clauses" that would allow them to cooperate with PEMEX in the development of that area. Such performance clauses are specifically authorized by NAFTA. This is a good start, one that would allow more investment without having to change the Mexican legal framework.



# Energy Reforms in the Short and Long Term

Pamela Starr

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I would like to look at some of the political constraints to change in the petroleum sector in Mexico and the kind of reforms I believe are actually possible in the near and medium term. *I think the best starting point for this discussion is to note that the political constraints to change in Mexico currently obviate any far-reaching solutions to the problem, including the ever-present call for a “change in the constitution.”* Let me explain why I believe this to be the case.

Right now, even though Pemex undoubtedly faces some serious technical challenges in the coming years, the core constraints to change in the Mexican energy sector are political and are a consequence of the distribution of political power in the country. President Felipe Calderón lacks a majority in the national legislature. Although there is a possibility that his National Action Party could pick up the handful of seats needed to comprise a majority in the Chamber of Deputies in the 2009 mid-term elections, the divided membership Senate will remain unchanged until 2012. Calderón also faces the Mexican left’s decided opposition to the core elements of his economic policy strategy. That means that in order to get anything done Calderón has to deal with the Institutional Revolutionary Party, or PRI, the party that governed Mexico for over 70 years until 2000. But the PRI is far from a loyal legislative ally of the president and it is internally divided on a key issue in the Pemex reform debate—the role of private investment and specifically, its participation in the core production chain, meaning exploration, production, and retail sales. Public opinion, meanwhile, continues to express its opposition to private investment in Pemex in poll after poll.

Let’s look at each of these key political obstacles to energy policy reform: the left, the PRI, and public opinion.

First, the government continues to face strong opposition from the left. There are many people who like to write off Andres Manuel López Obrador, the former presidential candidate of the leftist Democratic Revolutionary Party, or PRD, because he has not been very visible since President Calderón’s December 1, 2006 inauguration. Nevertheless, recent events and my personal conversations with PRD members show that PRD legislators, both Senators and Deputies, are unwilling to defy the spirit of López Obrador’s order not to have any contact with the Calderón administration. The left continues to believe that López Obrador lost the 2006 presidential election as a consequence of political machinations, and López Obrador thus continues to insist that the left have nothing to do with a “spurious” president who reached office illegally and unfairly. PRD legislators, however, want to do their job; they want to exploit the left’s control of nearly a third of congressional seats to legislate and thereby to advance some of the left’s traditional policy demands. This implies working with the government to a certain degree and thus defying López Obrador. Their ability or willingness to do so, however, is limited allowing López Obrador to act like a break on their actions in the legislature.

López Obrador controls the heart of the PRD’s electoral base. These voters continue to look upon López Obrador as their champion (a sentiment López Obrador has consciously cultivated in his cross-country speaking tours throughout 2007). This influence with the base gives López Obrador the ability to impose limits of acceptable political behavior on most PRD politicians. If

López Obrador concludes that his movement has been betrayed by a particular PRD politician, he can denounce that legislator as a traitor to the cause and rally his supporters to defeat that politician. Nor is this an unfounded fear. In July 2006, López Obrador's supporters successfully challenged the Governor of Zacatecas, who has openly defied López Obrador, by defeating most of her candidates to the state legislature. López Obrador also has significant power "on the streets." As a consequence of his close alliance with Mexico City Mayor, Marcelo Ebrard, López Obrador has the logistical and financial capability to mobilize his supporters—in electoral campaigns or in street protests. He has repeatedly filled Mexico City's central square, a traditional measure of organizational prowess in Mexico, in demonstrations of general support for his political cause. This suggests that he would be able to mobilize even larger protests in response to a touchstone issue for the left, such as energy reform.

This should not be interpreted to mean that López Obrador continues to dominate the PRD. He does not, in large measure, because of the negative impact on public opinion of his post-election strategy of civil disobedience and his continuing refusal to recognize Felipe Calderón as the president of Mexico. Yet neither can the more moderate politicians in the PRD blatantly defy López Obrador. The weekly meetings between López Obrador and PRD legislative leaders tend to be characterized by a struggle between these two sides with each trying to push forward their preferred opposition strategy. At present, the situation is at something of a stalemate. PRD legislators do negotiate with the government, albeit indirectly through Calderón's PAN legislators, but they feel they can only do so to the extent that the legislative outcome addresses the traditional concerns of the left. Otherwise, they would open themselves up to charges that they have betrayed the left.

This has translated into PRD support for the 2007 budget at the end of last year because it included old age pensions for poor rural residents, a reduction in Pemex's royalty payments, and an electoral reform that resulted in the staggered replacement of counselors from the Federal Electoral Institute, or IFE, and the immediate removal of the IFE president. Old age pensions and a tax cut for Pemex are core PRD issues that formed part of López Obrador's campaign platform, and the IFE president had become the symbol of all that was wrong with the 2006 election in the eyes of the left. But the PRD did not support the fiscal reform approved in September 2007, even though it included measures to increase taxes on business to finance social programs for the poor—a core PRD policy demand—ostensibly because of a regressive increase in the gasoline tax. But more likely supporting this legislation was simply a bridge too far—fiscal reform was Calderón's central legislative goal for 2007 and the key to many of this policy objectives. As such, supporting fiscal reform would weaken López Obrador's strategy of weakening the Calderón presidency through a policy of non-recognition; López Obrador would thus not countenance that level of PRD collaboration with "*el espurio*." But if fiscal reform was a bridge too far, PRD support for a far-reaching energy reform would be a continent too far.

The unwillingness or inability of the PRD to negotiate directly with the government and to make the policy compromises often needed to approve legislation has placed the PRI in the legislative driver's seat. Without the cooperation of the PRD, President Calderón cannot form a

legislative majority without the PRI. PRI leaders fully understand this and have actively exploited this political fact. The PRI held fiscal reform hostage throughout the spring and into the summer as part of its political strategy to win Yucatan's May gubernatorial election, successfully, and Baja California's gubernatorial election in July, unsuccessfully. The PRI then conditioned its support for fiscal reform on the exclusion of any sort of value-added tax, the inclusion of a large tax cut for Pemex and the parallel approval of an electoral reform. The Calderón administration opposed the tax cut as too large and the electoral reform because it feared that replacing the IFE counselors would be seen as validating the left's charge that the outcome of the 2006 election was not legitimate. Nevertheless, Calderón accepted the PRI's conditions in recognition of political reality—it was the only way to get fiscal reform through the legislature.

The PRI's willingness to support President Calderón's policy initiatives depends directly on the party leadership's calculus about the consequent political benefits. The party's strategy of driving a hard bargain but ultimately supporting key legislative reforms has thus far generated significant political benefits. The PRI was able to insert a number of changes into the fiscal reform that even the government admits improved the reform and to take full political credit for the Pemex tax cut and for leading the charge for a popular electoral reform. Applying this strategy to energy reform, however, will be more difficult given internal disagreements about energy reform within the PRI, the left's power to mobilize opposition, and the nature of public opinion on the topic. The PRI will hesitate to take a stance that could divide the party and undermine its political position.

Public opinion thus forms the third key obstacle to energy reform in Mexico. Poll after poll indicates that the Mexican public strongly opposes private investment, and most particularly private foreign investment, in the energy sector. How deep this opposition goes; however, is unclear. Does it mean a majority of Mexicans oppose private investment in transportation, refining, and primary petrochemicals, or just in exploration and production? Would they oppose private investment if they believed this was the only way to ensure the long-term viability of Pemex as a state-owned firm? Would they oppose private investment if they understood that this did not imply surrendering operational control of the firm? All this is unclear because the nature of popular opposition to private investment in Pemex has not yet been the subject of public opinion surveys. It is also unclear because no government has undertaken a concerted effort to shape public opinion about Pemex, its operations and the role of current and future private investment in the firm. Felipe Calderón is fully aware that modifying public opinion about energy reform is essential to effective policy reform and Pemex Director Jesus Reyes Heróles has begun efforts to move in that direction. Thus far the campaign, as a first step, has been limited to reminding the population of the difficult straits Pemex is in and the consequent need to carry out serious reforms to fix it. In the short and medium-term, therefore, the nature of Mexican public opinion is apt to serve as powerful political fodder for the left's strident opposition to increased private investment in Pemex and as a brake on the PRI's willingness to support far-reaching reforms.

What does all this mean for the kind of energy reform we can expect in the years ahead? Since the conventional wisdom in Mexico points to Pemex's onerous tax burden as the source of most of the firm's difficulties, it was almost inevitable that reform would begin here; even though it

is well known in energy circles that money alone will not fix Pemex's problems. The tax cut for Pemex approved by the Mexican legislature in early September 2007 reduces the firm's royalty payments from 79% to 74% in 2008 and an additional 0.5% each ensuing year until it settles at 72.4% in 2011. This reform will allow Pemex to retain an estimated \$3bn in 2008 and an additional \$1.5bn by 2011 at current oil prices.

The next step in energy reform is apt to be a series of legal changes designed to increase Pemex's operational autonomy. In the words of former Pemex Director Adrian Lajous, Pemex is "over-regulated, poorly regulated, and operates in a variety of regulatory voids," and consequently exhibits all kinds of operational inefficiencies. Fixing some of these regulatory limitations and thereby allowing Pemex to operate more like a real petroleum company is now the focus of energy reform efforts in the congress. Such a reform would make changes in Pemex's organic law and the public works law to allow for more flexibility in subcontracting and more independent decision-making, among other things. It also seems almost certain that these legal changes will win congressional approval in early 2008 because, much like the Pemex tax cut, nearly every Mexican politician agrees that this needs to be done. All three major party presidential candidates included increasing Pemex's operational autonomy in their 2006 campaign platforms, including the PRD's López Obrador. And my conversations with PRD legislative leaders have made it clear that they will vote for the next phase of energy reform, "if this is all that's in it," as one PRD congressman put it.

The real question is: is this all there is? Are we likely to see other reforms that allow for private ownership of limited amounts of stock in the company, for expanded private investment in transportation and refining, revisions of the law governing private investment through multiple-service and integrated-service contracts, or a limited reform of the constitution that would allow for private ownership of Mexican petroleum extracted from deep water fields? These reforms become more difficult politically and, hence, less likely to be approved in the near term as we proceed down the list.

For some time now, there has been a proposal floating around in the Mexican Congress that would allow Pemex to issue limited stock options in the company. Under this scheme, Pemex would sell stock to the national development bank (NAFIN) and the bank would sell limited quantities of limited stock options to private individuals. These financial instruments would pay investors dividends from Pemex profits, but provide no ownership rights. This proposal continues to kick around the halls of congress because of the ultimately limited size of the reduction in Pemex's royalty payments that takes effect in 2008. The value of the tax cut is a fraction of \$10–12 billion in debt Pemex has taken on annually in recent years to cover its investment expenditures in exploration and production. The problem with the limited stock option scheme and the reason that it is unlikely to become law in the near term is that Pemex has been operating in the red or with very minimal profits for years. Without the expectation of profits, there would not be much demand for limited stock options in the firm.

The overriding question about changes to the legal framework governing Pemex operations that are likely to receive legislative approval in the coming months is: will it include a modification

of the multiservice contracts? These contracts allow Pemex to outsource petroleum exploration and production to private firms but retain ownership of the oil and gas extracted from these operations, as required by the constitution. Right now, the law limits these contracts to a fixed fee for service. In other words, oil companies agree to provide the contracted services to Pemex in exchange for a fixed sum of money. This kind of contract makes sense in economic activities where the investment risk is limited and/or knowable with a high degree of probability. In petroleum exploration and production, however, risk is not only significant, it is highly variable and difficult to estimate before a project begins. Many of the companies that invested in gas exploration and production under multiservice contracts in the Burgos Basin region, located in the state of Veracruz, have either lost money or have not made a profit on their investments because the cost of their operations exceeded what they anticipated when negotiating their contracts. The proposal currently under consideration in the Mexican Senate would change the law governing multiservice contracts to allow Pemex to sign contracts with private oil companies that guarantee a payment for their services based on a percentage of the value of the resulting production.

This proposal is supported both by the PRI and the PAN and Francisco Labastida, the President of the Senate Energy Committee and the man leading the energy reform effort in the congress and who is trying to build a coalition backing this legal change. Technically this would only require a majority vote since no change of the constitution would be involved, but Labastida and the PRI are hesitant to push forward with this reform absent the backing of PRD legislators. Nor is this merely a pipedream. The more moderate members of the PRD group in the legislature support this reform behind closed doors, but they would never say so in public because of the likely reaction of Andres Manuel López Obrador.

López Obrador has made it clear that petroleum is the issue on which he expects to make his stand. He believes he can exploit this issue very effectively to undermine the legitimacy of and support for the Calderón government. Strong opposition to what he calls the “privatization” of Pemex in the PRD base, and broader public discomfort with increased private investment in Pemex operations, should provide the raw material needed for López Obrador to lead mass protests in the streets—the mobilization from below he believes is the only way the left will ever be able to come to power in Mexico.

The likelihood that Pemex reform will extend beyond tax reforms and increased operational autonomy for the firm thus depends heavily on the left, and specifically on López Obrador and the more radical faction of the PRD he represents. These actors will attempt to exploit this issue. So the question is: where do they draw the line and to what effect? I think it is pretty clear that legal changes that would permit private investment in refining and petrochemicals are well over their line in the sand. Recent statements by López Obrador further suggest that he would exploit a PRI/PAN effort to change the multiservice contracts as well. Given his influence among loyal PRD voters, his alliance with Marcelo Ebrard in Mexico City, and his belief that the “privatization” of Pemex is an issue that resonates well beyond the PRD base, I think there is a high degree of probability that the PRD would take to the streets to block these initiatives. At the same time, Felipe Calderón does not seem interested in an open confrontation with López

Obrador and his faction of the Mexican left—at least not yet. To the contrary, his strategy is to avoid actions that could energize and unify the Mexican left behind the intransigent position held by López Obrador while undertaking actions that gradually weaken the more radical segments of in the PRD.

Any Pemex reform that allows for more private participation in exploration and production thus appears to be off the agenda for now. In fact, I have been told by legislative leaders from all three parties that this is unlikely, with one going as far as to say that anything having to do with extraction is “off the table.” This pessimistic scenario could change, but that would require a significant weakening of López Obrador’s control over the PRD base and his ability to mobilize mass protests and political vendettas against “wayward” PRD politicians. While I currently give this scenario only a 25% probability, it is not impossible. If it were to occur, its most likely form would be a revision of the multiservice contracts for three reasons. First, Pemex is asking legislators for this reform. Second, the PRI legislative leadership supports this reform as long as the political costs of doing so are limited. And three, these complex contracts are hard for the general population to understand and thus more difficult for the opposition to exploit than, for example, the private construction of an oil refinery.

In the medium-term, Calderón’s strategy is to lay the political groundwork in 2007 and 2008 for a strong PAN electoral showing and a PRD collapse in 2009. To achieve this outcome, the government is wedded to a strategy of pragmatic moderation. This means keeping the left off balance while appealing directly to its constituency through programs to alleviate poverty, increased taxes on the rich, and going after monopolies (albeit very carefully). This also means avoiding touchstone issues for the left, such as a visible expansion of private investment in Pemex. It means accumulating a list of policy achievements that demonstrate to the broader electorate that Calderón is getting things done and moving the country forward. And this requires accepting small reforms and compromises when the alternative is no reform at all.

If this works, if the PAN and PRI gain seats in the lower house in 2009 and if the PRD vote falls back to its traditional 15%–18% of the electorate, the Calderón administration will argue that the electorate has validated his policies and given him a mandate that was absent in his narrow and disputed 2006 victory. This scenario would give Calderón increased room for policymaking, including in the area of energy reform. It is hoped that this would lead to reforms that would permit private investment in transportation and storage, and potentially in refining as well. Ideally it would also make it possible for Calderón to engineer a limited constitutional reform that would enable Pemex to form strategic alliances with international oil companies, or national oil companies such as Petrobras, in the exploration and production of the super deep waters of the Gulf of Mexico, those over 1500 meters.

Even with an overwhelming PAN victory in 2009, however, such a reform of article 27 of the Mexican constitution will be difficult to obtain because of the nature of public opinion and the logistical difficulties of approving constitutional reforms in Mexico (much like the United States, a constitutional reform requires a two-thirds majority in both houses of the national legislature and a simple majority in half of the state legislatures).

So, several things are clear. The legislature will approve additional Pemex reforms, and these will almost certainly include measures to increase the firm's operational autonomy. Anything beyond this—anything that touches the sale of Pemex assets, even outside the core production chain, or anything related to petroleum extraction—will be very difficult to approve prior to the 2009 mid-term elections. If a reform related to extraction were to be approved prior to 2009, it would require a shift in the current balance of political power in Mexico away from Andrés Manuel López Obrador and his allies, and it would most likely be limited to increasing flexibility in multiservice contracts. Any reform of the constitution, even a limited one, will be very difficult to implement, even if the PAN wins a significant victory in the 2009 mid-term elections. And the actual pace of reform is unlikely to be dramatic. It is instead liable to reflect President Calderón's belief that the best way to advance Mexico's reform agenda is one step at a time.

Will this be enough to arrest the current decline in Mexico's proven oil and gas reserves and to avert a significant drop in production? This is unclear and analysts do not agree. I will leave a definitive answer, if there is one, to petroleum industry experts.



## Biographies of Authors

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LUIS DE LA CALLE is the managing director and founding partner of De la Calle, Madrazo, Mancera, S.C. (CMM). He also teaches at the Instituto Tecnológico Autónomo de México (ITAM). Prior to joining the private sector, Dr. de la Calle served as Undersecretary for International Trade Negotiations in Mexico's Ministry of the Economy under former Presidents Vicente Fox and President Ernesto Zedillo. In this capacity he negotiated several of Mexico's bilateral free trade agreements and regional and multilateral agreements with the World Trade Organization. During his term as Undersecretary he was a member of the Board at Pemex Exploration and Production and at the national forest commission; he was also Executive Secretary of the national foreign investment commission. Previously, Dr. de la Calle served as Trade and NAFTA Minister at the Mexican Embassy in Washington, D.C. as well as Country Economist for the Czech and Slovak Republics, Poland, and the former Zaire at the World Bank.

Dr. de la Calle is member of the Institute of Public Council on Agriculture, Food and Trade, the *Consejo Mexicano de Asuntos Internacionales*, the *Instituto Mexicano para la Competitividad*, and is currently member of the Board of Aeroméxico. He has a long list of publications and writes a bi-weekly column entitled "¿Qué más?" for the Mexican daily *El Universal*. He received Ph.D. in Economics from the University of Virginia.

JOSÉ LUIS ALBERRO is a Director of LECG (<http://www.lecg.com/>). He was the founding CEO of PEMEX Gas and Petrochemicals (PGPB) between 1992 and 1994 and PEMEX's chief representative in the NAFTA negotiations between 1990 and 1992. Dr. Alberro had a distinguished career as a public official in the Mexican Government for 15 years in the Secretary of the Treasury (SHCP), the Secretary of the Budget (SPP) and the Secretary of Commerce and Industrial Promotion (SECOFI). Dr. Alberro taught economics at universities in the United States, Mexico and the United Kingdom and has published over thirty articles. He is a member of the Mexican Academy of Science, the Mexican Academy of Law and Economics, and the Mexican Council on Foreign Relations. Dr. Alberro holds a Ph.D. in Economics from the University of Chicago.

PAMELA K. STARR is associate director of the USC Latin America Initiative, a senior fellow at the USC Center on Public Diplomacy, and a senior lecturer in Public Diplomacy and the School of International Relations. She is also a senior consultant for the Eurasia Group and serves on the editorial board of *Foreign Affairs en Español*. She is an active speaker, commentator and author on Mexican politics and political economy, and on the making of economic policy to a wide range of audiences, including the World Economic Forum, the IMF, the US Department of State, and the Mexican Senate. Previously, she was a professor of political economy at Instituto Tecnológico Autónomo de México (ITAM) for eight years where she specialized in contemporary Latin America. Dr. Starr has also worked as a consultant to investment banks and securities firms, an advisor on Latin American issues for a Mexican senator, and as a lecturer on the staff of the Foreign Affairs Committee of the Mexican Senate. Starr has held research positions in Argentina and Brazil and at the Center for Strategic and International Studies (CSIS) in Washington, DC and has received grants and fellowships from the Pew Charitable Trusts, the Earhart Foundation, the Organization of American States and the Woodrow Wilson International Center for Scholars.

Dr. Starr's research and writing focuses on two main topics: the politics, economy and foreign policy of contemporary Mexico, and more broadly the politics of economic policy-making across Latin America. She received her PhD from the University of Southern California in 1993.

ROGER W.WALLACE is the vice president for government affairs at Pioneer Natural Resources Company, an independent oil and gas company based in Irving, Texas. Formerly he served as president and CEO of Investamex, an investment and consulting firm he co-founded in 1993 focusing on business opportunities in Mexico and Latin America. He was deputy undersecretary for international trade at the U.S. Department of Commerce and minister-counselor for commercial affairs with the U.S. Embassy in Mexico City.

He is currently co-chair of the Advisory Board to the Wilson Center's Mexico Institute, serves on the Board of the Atlantic Council, is a member of the Council on Foreign Relations, and is Chairman of the Inter-American Foundation.

He has a B.A. from Washington and Lee University and an M.A. from the Fletcher School of Law and Diplomacy.



**Woodrow Wilson  
International  
Center  
for Scholars**

*Mexico Institute*

1300 Pennsylvania Ave., NW  
Washington, DC 20004-3027

Tel 202.691.4399

Fax 202.691.4076

[mexico@wilsoncenter.org](mailto:mexico@wilsoncenter.org)

[www.wilsoncenter.org/mexico](http://www.wilsoncenter.org/mexico)

