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US-Mexico Cross Border Energy Cooperation: a new era in the Gulf of Mexico

Duncan Wood
Professor, Instituto Tecnológico Autónomo de México
Senior Adviser, Mexico Institute, Renewable Energy Initiative

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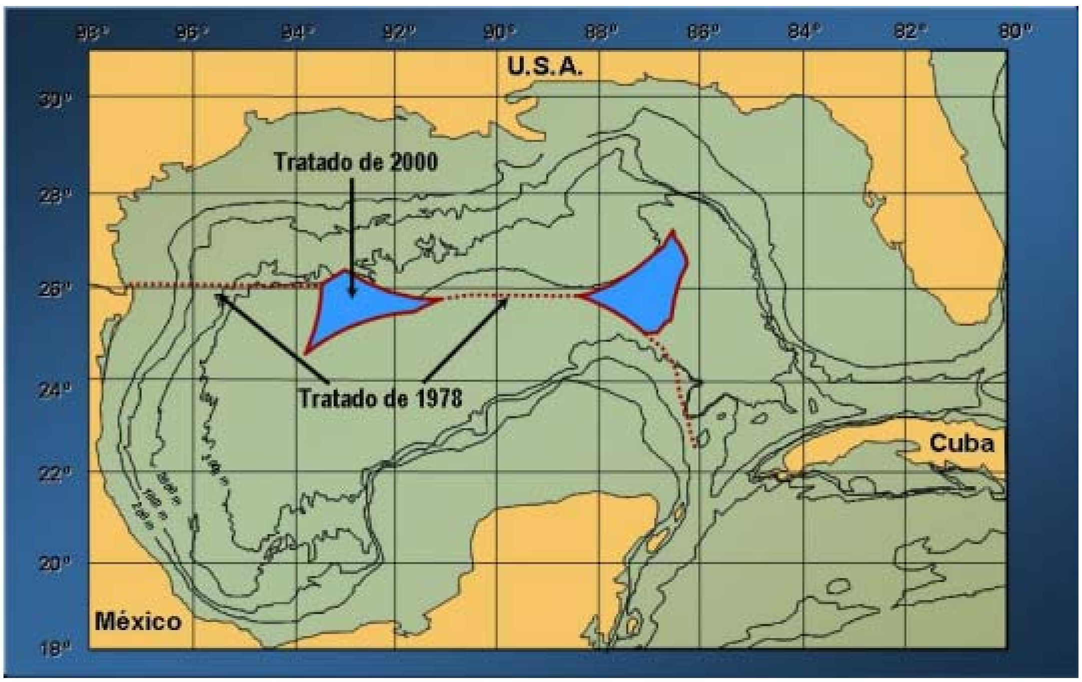
On the 20th of February, the governments of Mexico and the United States signed a Transboundary Hydrocarbons Agreement that resolves the question of what to do with potential oil reserves along the dividing line between the two countries in the Gulf of Mexico. Two areas in particular have been disputed for a number of years: the Western and Eastern polygons, or "donut holes" as they are more colloquially known, comprise over 500 miles of the maritime border between the two countries and are thought to hold billions of barrels of crude oil (though nobody is sure quite how much, as comprehensive seismic scans have not been undertaken). The signing of the treaty is extremely good news as it marks the end of a decades-long process to try to determine oil rights in these two areas, opening the door to exploration and production that offers the prospect of exciting new modes of cooperation between Pemex and private oil companies.

<u>Map of the Western and Eastern Polygons</u>



The question of what to do with the Gulf of Mexico's donut holes goes back to the 1970s. Following on from negotiations in the United Nations over the International Law of the Sea, the two countries came together to determine ownership of resources found in these two areas that were beyond their two-hundred miles exclusion zones but entirely surrounded by them (thereby not qualifying as international waters). Early discussions over the areas broke down, but in the late 1990s the two countries agreed to a ten year moratorium on exploration and drilling in order to be able to negotiate a mutually agreeable settlement.

In 2008, Mexico's energy reform legislation committed the Calderon administration to seek a solution to the issue and, when the ten-year deal expired in 2009, the two governments agreed to begin negotiations towards a binding deal. In the first year of the talks, the parties engaged in a process of information exchange, discussing standards, emergency management procedures and existing seismic data. This data exchange, it is vital to recognize, was not aimed at establishing what resources might exist in the region, but rather what geological structures might exist, thereby giving clues to potential oil fields. In 2010, following a commitment made by Presidents Obama and Calderon to negotiate a transboundary agreement, Mexico and the U.S. determined who would be the leading actors involved in the negotiations, and then both sides agreed on an extension of the 1999 moratorium for four more years. In 2011, preparatory meetings were held, with official negotiations beginning in August. These negotiations were concluded in December and the Treaty was signed on February 20th, 2012.

The new agreement has already drawn attention and controversy, even before its contents were revealed to the public. After the announcement of the signing of the deal, critics from the left in Mexico declared that the Calderon administration had sold out to the United States, bowing to pressure from Washington and from U.S. oil interests to sign a deal that gave disproportionate benefits to the Americans. Voices from the government rejected these accusations, but it was only last week, when the Treaty was presented to the Mexican Senate for ratification, that the true nature of the deal became known to the public. Ratification is expected to be relatively easy as the Mexican Senate was consulted frequently during the negotiation process.

The Treaty does not pre-determine the division of oil wealth in the border regions. Rather it establishes a framework for dividing production based upon a mutually-agreed evaluation of the size of the resource, the unitization of the field, and the designation of an operator. Furthermore, in the fashion of Stephen Krasner's classic definition of an international regime, the agreement outlines "norms, rules and decision-making procedures around which actor expectations converge". The two sides have agreed upon the procedure for identifying a resource, for notifying all concerned parties, for determining the distribution of the resource and for dispute settlement.

The Treaty establishes that information must be exchanged on oil-related activities within 90 days of the entrance into law of the treaty; both governments must report on activities occurring on their side of the dividing line in the Gulf. However, if activity occurs within a 3 mile area, notification must be automatic. As soon as an oil field is identified, production of the resource is prohibited until the two countries have come to an agreement to unify the oil reserve. At this point the two sides will exchange information about the field, and determine whether it is a cross-border resource or not. If the two sides cannot agree, an independent arbitrator will be called in to decide on the issue. The process of unitization of the field will then begin in order to determine the division of oil from the field.

The next stage in the procedure involves determining a development plan for the field and choosing an operator. In Mexico, this stage has been seen as highly controversial given that a foreign and private oil company may begin to exploit "Mexican" oil, even though it is drilling on the U.S. side of the donut hole, due to the flow of oil within the field. While it is true that private companies have been extracting oil in Mexico through contracts for the past year, the new arrangement is sensitive because of the long-term perception in Mexico that the U.S. could siphon off Mexican oil in border areas. The oil produced, however, will be divided up according to the established percentages, and those barrels will be given to their respective "owners". This means that oil that has technically come from the Mexican side of the border will be returned to Pemex, who will then process and commercialize it. Even more controversially, the Treaty allows for the tantalizing prospect of operators other than Pemex to drill for oil on the Mexican side of the Gulf. If and when this happens, it would mark an extraordinary step forward in breaking the taboos over foreign companies and Mexican oil. A key point that has been emphasized by the Mexican government, however, is that the goal is to maximize the recovery rate from each resource, so as to maximize the economic returns from oil production. It is for this reason that a company other than Pemex may be chosen, depending on the nature of the field and the capacities of the company concerned. And of course, once again the oil would be the property of the Mexican state.

If the U.S. and Mexican governments cannot agree on a development plan or operator, the default position determined by the Treaty is for each side to produce independently, up to the maximum percentage of the resource allocated by the unitization agreement. This would likely be a suboptimal outcome, as two operators would be less able to maximize the recovery rate.

In the design of the Treaty, the two sides studied existing cross-border oil agreements around the world, and the negotiators claim to have incorporated the lessons from those deals into this one. In fact, the bilateral agreement goes beyond. Within the agreement there is a mechanism by which, if later studies discover that the original unitization agreement is shown to have been incorrectly calculated (by later seismic studies), the allocations can be reworked by giving the side that lost out a higher percentage of future production. This is an issue that has always been incredibly difficult to negotiate in other agreements, but the Mexican and U.S. governments have blazed a trail by institutionalizing this mechanism in the deal.

One of the lingering questions that have been raised by some oil insiders in Mexico is why the private sector in the U.S. has supported this deal. On the U.S. side of the border, 305 blocks have already been identified, with permits issued for 32. Two of these blocks in the Great White field are already in operation (although production has not begun). Of the remaining blocks, it is highly unlikely that any will be in production before the Treaty comes into force. The Treaty will apply retroactively unless it damages any of those interests, perhaps helping to explain why the private sector is on board with the deal. More importantly, however, the companies were consulted heavily in the period leading up to the negotiations. Furthermore, as Mexican officials have been keen to point out, the International Oil Companies (IOCs) are enthusiastic that the Treaty gives them legal certainty in the E&P activities in the border regions. Rather than risk protracted legal battles in international courts should Mexico challenge any future discoveries, the IOCs can now work within an established framework in which risks are more easily quantified.

The Transboundary Agreement is a major step forward for energy relations between the two countries, providing a major boost to Pemex as it tries to improve its reserve position and its production outlook. The prospect of significant oil discoveries in the border region, and the possibility of working alongside the private sector, is intriguing and controversial, to say the least. What is certain is that the Treaty sets a new framework for cooperation between the two countries that will produce new ways of thinking about oil production in Mexico, an issue that will surely be of importance in the looming debate over energy reform.

About The Author

Duncan Wood
Professor, ITAM
Senior Adviser, Woodrow Wilson International Center for Scholars, Mexico Institute, Renewable Energy Initiative

Duncan Wood is professor and director of the International Relations Program at the Instituto Tecnológico Autónomo de México (ITAM) in Mexico City. He is also a researcher in the Centro de Derecho Económico Internacional (CDEI) at ITAM. He is a member of the Mexican National Research System (level 2), a member of the editorial board of Foreign Affairs Latinoamérica and has been an editorial advisor to Reforma newspaper. In 2007, he was a non-resident Fulbright Fellow. Between 2007 and 2009, he was technical secretary of the Red Mexicana de Energía, a group of experts in the area of energy policy in Mexico. He is a Senior Associate with the Americas Program at the Center for Strategic and International Studies (CSIS) in Washington D.C. His research focuses on Mexican and Latin American energy policy, including renewable energy; North American relations; and banking supervision and the political economy of international finance. He studied in the UK and Canada, receiving his PhD in Political Studies from Queen’s University, Canada in 1996.