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Reforms in the Mexican Petrochemical Industry Have Not Increased U.S. Investment

Statement of
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Mr. Chairmen and Members of the Subcommittees:

I am pleased to be here today to testify before the Subcommittees about our preliminary observations on issues regarding U.S. investment in Mexico's petrochemical industry.

Our review, which is still ongoing, has focused on obtaining information about (1) the Mexican petrochemical[1] industry's investment needs, (2) the 1989 reforms made by Mexico in its petrochemical industry and the U.S. petrochemical companies' response to these reforms, (3) the major impediments discouraging U.S. companies from investing in Mexico's petrochemical industry, and (4) the factors encouraging U.S. investment in Mexico.

MEXICO'S PETROCHEMICAL INDUSTRY

Mexico's petrochemical industry has grown rapidly from its inception in the 1950s. However, a shortage of capital after the onset of the debt crisis in 1982 sharply reduced investment in the industry. As a result, Mexico is confronting continuing shortages

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[1]Petrochemicals are created by breaking oil and natural gas into their basic chemical components, or "feedstocks." These feedstocks are then transformed into a wide variety of intermediate petrochemical compounds, which in turn are processed or combined with other chemicals to create finished consumer products ranging from nylon stockings and styrofoam cups to antifreeze and compact disks.

in both investment funds and feedstock supplies for its petrochemical industry.

-- An adequate future supply of Mexican natural gas, the primary raw material for the petrochemical industry, is in jeopardy because of the lack of investment. Since 1982, Mexican production of natural gas has been slowly declining. The major reason for this decline has been the lack of financial resources for natural gas exploration and development. Industry experts forecast a continued fall in natural gas production unless Petroleos Mexicanos (PEMEX), the government-owned oil company that operates all of Mexico's basic petrochemical production as well as some of its intermediate petrochemical production, substantially increases its investment in natural gas exploration and development.

-- A number of petrochemical projects that the Mexican government began in the early 1980s are incomplete, due to insufficient investment funds. PEMEX is short approximately $1.7 billion required to complete 21 investment projects planned a decade ago in order to meet Mexico's demand for petrochemicals.

-- Because PEMEX does not have enough installed basic petrochemical capacity, it depends on imported basic petrochemicals to supply its industry. Between 1980 and 1988, Mexico spent about $5.5 billion to import these feedstocks.

-- The Mexican trade deficit in basic petrochemicals is expected to grow because of insufficient investment in feedstock plant capacity. The Mexican Petrochemical Commission believes that Mexico would need to invest several billion dollars in petrochemical plant capacity through 1995 in order to meet projected demand. Without this investment, the need for dollars to pay for petrochemical imports will grow even greater.

Restrictions On Investment in Petrochemicals

Mexican law imposes restrictions on both foreign and private Mexican ownership of petrochemical production. The Mexican government has the exclusive right to produce and distribute all "basic" petrochemicals, or petrochemical feedstock. While the law allows private investment in "secondary" or intermediate petrochemicals, which result from chemical transformations of basic petrochemicals, the law limits direct foreign investment to no more than 40 percent of the plant equity.

In 1986, the Mexican government began to change its petrochemical policies. Mexico increased the opportunities for foreign investment in the petrochemical industry by reclassifying 36 products from the basic to the secondary category. Thirty-four products continued to be defined as basic petrochemicals.

MEXICO'S RECENT PETROCHEMICAL REFORMS

In 1989 the Mexican government instituted further reforms to increase foreign investment in the petrochemical industry.

-- The Mexican government reduced from 34 to 20 the number of petrochemicals classified as basic. At the same time, the government decreased the number of petrochemicals classified as secondary from over 700 to 66 and for the first time provided a definitive list of these products. All petrochemicals not included in these two categories are unregulated and therefore open to 100-percent private and foreign ownership.

-- The Mexican government gave foreign investors the ability to acquire 100-percent ownership of a secondary petrochemical plant if they establish a special trust with a Mexican credit institution. The trust would give the foreign investor the profits from the venture, while direct control would remain with the trustee.

-- PEMEX created a program to obtain private or foreign investment in its basic petrochemical plants. In exchange for capital funds to construct the plant, PEMEX promised to repay companies with petrochemical products from the plant. Under PEMEX supervision, the companies can build the plants but PEMEX must be the operator.

-- The Mexican government established definite time frames for processing petrochemical permits to produce secondary petrochemicals, thus reducing bureaucratic delays.

In 1990 PEMEX formed a petrochemical subsidiary to specialize in marketing petrochemical products. The U.S. State Department reports that this move is intended to counteract the tendency for PEMEX's oil operations to take precedence over its petrochemical operations.

U.S. Companies' Response to Mexico's Petrochemical Reforms

According to Mexican government and industry officials, despite the Mexican government's petrochemical reforms, private U.S. petrochemical companies generally have not substantially increased their investments. We contacted 20 U.S. petrochemical companies known to be interested in doing business in Mexico. Four of these companies have investments in Mexico's petrochemical industry. However, only one of these companies' investments was made after the recent reforms, and none is producing the petrochemicals recently opened to foreign investment.

MAJOR IMPEDIMENTS TO U.S. INVESTMENT

About half of the U.S. companies we talked to told us they are considering investing in Mexico's petrochemical industry. However, they are hesitant because of current world market conditions, insufficient feedstock, reversible petrochemical reforms, inadequate protection of intellectual property rights, and lack of formal investment protection.

Current Market Conditions

The world market currently has excess production capacity for basic petrochemicals, and present market conditions may not warrant additional investment in plant capacity. Mexico's 1989 petrochemical investment reforms occurred after the cyclical demand for petrochemicals peaked in 1988; analysts now predict that world markets will be stagnant and oversupplied through 1991. U.S. companies currently are exporting excess supplies of petrochemical feedstock to Mexico.

Insufficient Feedstock

Some U.S. company representatives told us that to make investment in Mexico attractive, they would require a guaranteed supply of feedstock, which Mexico is currently not able to provide because of insufficient productive capacity. To encourage foreign investment in such capacity, even more feedstocks than were reclassified in the 1989 reforms must be removed from government control.

According to a Department of Commerce official, the Mexican government could reduce the list of 20 basic petrochemicals by about 50 percent and still control the major raw materials for the petrochemical industry. PEMEX officials said that some petrochemicals currently classified as basic could be reclassified under Mexican law. However, additional reclassification is domestically considered to be a politically sensitive issue.

Reversible Petrochemical Reforms

Most U.S. company representatives told us that because the petrochemical investment reforms were made by administrative decree rather than by changing the law, the reforms are subject to greater risk of reversal. For example, a representative from a company that has never invested in Mexico told us that his company would not approve a major investment project without having some evidence that the ground rules would not be changed.

Mexican Foreign Investment Commission officials, however, cited two industries where similar administrative changes have not been a barrier to substantial foreign investment: tourism and automobile manufacturing. Therefore, they believe that administrative changes to investment regulations should not be viewed as an impediment to foreign investment in the petrochemical industry.

The administrative changes to investment regulations may not be as threatening to established investors as they are to companies with no investment experience in Mexico. One U.S. petrochemical company that has invested in Mexico's petrochemical industry for many years told us that it has been able to negotiate with the Mexican government to obtain profitable investment arrangements.

Inadequate Protection of Intellectual Property Rights

Most U.S. companies we spoke to were concerned about the protection of patents and technical expertise in Mexico. While the production technology for basic petrochemicals is widely available, the protection of specialized equipment or plant design for more complex petrochemical production is a problem. Furthermore, U.S. companies are troubled by the infringement of patents on products derived from "specialty" petrochemicals, such as perfumes, detergents, herbicides, and pharmaceuticals.

American Chamber of Commerce of Mexico officials told us that new legislation to strengthen intellectual property rights was to be passed by the Mexican Congress in December 1990. The legislation was not voted on, however, and is expected to be addressed in the session of the Mexican Congress that begins this week.

Lack of a U.S.-Mexico Investment Treaty

Most of the U.S. companies told us that the lack of a U.S.-Mexico bilateral investment treaty, which the United States commonly uses to help protect U.S. investors in foreign countries, deters them from investing in Mexico.

A Mexican attorney specializing in foreign investment noted, however, that U.S. investors were not at risk because the government of Mexico had fairly compensated foreign companies when assets were nationalized in the past. Mexico's Secretariat of Commerce and Industrial Development does not see the need for a bilateral investment treaty when so many major U.S. companies are already operating in Mexico without one.

FACTORS THAT ENCOURAGE INVESTMENT

Government officials from both Mexico and the United States believe that Mexico's established manufacturing infrastructure, its location, and the complimentarity of U.S. and Mexican companies provide strong incentives for attracting U.S. investment in Mexico's petrochemical industry.

Manufacturing Infrastructure

Mexico has an established infrastructure for manufacturing petrochemicals. Today, Mexico's petrochemical industry has about 700 plants that produce about 585 different products. Furthermore, the Mexican basic petrochemical industry contains world-class plants using up-to-date technology equivalent to plants in the United States and Canada. Mexican and U.S. officials also agree that Mexico has skilled managers and lower-cost labor, land, and construction than the United States.

Location

High transportation and storage costs for feedstock make it most economical for producers of secondary petrochemicals to locate their plants near feedstock sources. Companies that do so in Mexico can more efficiently distribute their products internally as well as to the North American, Asian, and European markets.

Complimentarity

Mutual benefits from investment and trade can accrue from the complimentary nature of the U.S. and Mexican petrochemical industries. Mexico potentially has abundant feedstock but needs the technology and investment it could obtain from U.S. companies to develop its petrochemical industry. According to the Department of Commerce, U.S. companies will be decreasing production of basic petrochemicals and expanding their production of more valuable finished petrochemical products. To expand successfully and compete in the global marketplace, the U.S. companies will need access to lower-priced feedstock.

In summary, cooperation between the two nations regarding the petrochemical industry could help U.S. companies maintain their positions in a competitive global market, while at the same time provide Mexico with much-needed capital investment.

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Mr. Chairmen and Members of the Subcommittees, this concludes my prepared statement. I will be happy to answer any questions you may have.

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