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U.S. Government Approves Crude Oil Swaps with Mexico While Congress Considers Repealing the Underlying Export Restrictions

On August 14, 2015, the U.S. Department of Commerce's, Bureau of Industry and Security (BIS) indicated that it would approve a number of export license applications permitting parties in the United States to swap crude oil with counterparties in Mexico. These decisions could open a new market for U.S. oil producers who are faced with an oversupply of light crude oil and have been previously foreclosed from this export market by the U.S. ban on crude oil exports. To take advantage of this opportunity, U.S. companies will need to structure swap transactions with Mexican companies that satisfy BIS's criteria for approval. Companies may also want to consider engaging with lawmakers in Congress who are currently contemplating legislation to repeal the export ban on crude oil altogether.

Background

U.S. law, namely the Energy Policy and Conservation Act, has essentially banned the export of crude oil since the 1970s. As discussed previously, the legal framework, which is primarily codified in BIS's Export Administration Regulations (EAR), has multiple exceptions that allow for licensed exports of crude oil in certain narrow circumstances, such as exports to Canada.

BIS also has the authority to approve export licenses for swap transactions, particularly with adjacent countries, that are "consistent with the national interest and the purpose of the Energy Policy and Conservation Act." Specifically, the EAR directs that these applications must (i) result in a true swap in terms of quantity and quality, (ii) have contractual terms to allow them to be terminated in case of national emergency, and (iii) demonstrate compelling economic or technological reasons, beyond the control of the applicant, why the crude oil cannot reasonably be marketed within the United States.

Up until recently, BIS did not receive a high volume of export license applications, particularly for swap transactions. However, this reality has changed due to the substantial increase of domestic oil production in recent years. This increase has made it very difficult for the United States to fully utilize existing production because more light crude oil is in the local market than can be absorbed. Nevertheless, imports continue because U.S. refineries were originally designed to handle, and have been processing, heavy crude oil imported from a variety of sources, including Canada, Mexico and Venezuela.

Heavy crude oil is more dense and has an API gravity of less than 20 degrees, with extra-heavy oil having a density of less than 10 degrees API. Heavy oil also tends to have substantially more sulfur (i.e., "sour oil") and is more difficult and complex to refine. Light crude oil, such as West Texas Intermediate (WTI), which is significantly less dense and has an API gravity of 39.6, typically trades at a higher price than heavy crude oil as it produces a greater percentage of gasoline and diesel when refined.

With that in mind, since a substantial portion of the unconventional oil added to U.S. production is light crude, such as WTI, U.S. refiners cannot easily process this product without modification to their existing infrastructure. Consequently, swapping U.S. light crude oil for imported heavy crude would allow the product to be more efficiently processed in current market conditions. This reality has caused a number of companies to seek approval from BIS for swap transactions between the United States and Mexico.

Approval of Swaps with Mexico

As previously mentioned, BIS signaled its impending approval of a number of swap transactions involving Mexico. These applications had been pending with BIS for a number of months, and it appears that the Obama Administration has made a policy decision to generally permit such applications with Mexico when they meet the requisite criteria. At least one of these applications reportedly involves Mexico's state oil company Petroleos Mexicanos, SA ("Pemex") and could involve an exchange of as much as 100,000 barrels per day or approximately 1 percent of current U.S. output.

In its statement to Congress, BIS noted that it has also denied a number of applications for similar swap transactions with other countries, presumably that are not adjacent to the United States. This announcement is consistent with the existing legal framework that favors crude oil exports with adjacent countries. Moreover, it highlights that crude oil exports will continue to be heavily restricted unless Congress takes action to repeal the export ban.

Congressional Debate

Legislation to lift the crude export ban entirely is advancing in Congress although it is unclear whether the sufficient votes currently exist, especially in the Senate, to send such a measure to the President for signature.

When Congress returns this fall, the House of Representatives will likely consider legislation (H.R. 702) sponsored by Congressman Joe Barton (R-TX) to repeal the provision of the Energy Policy and Conservation Act of 1975 that directs the President to restrict the export of crude oil. Barton recently stated that he has secured a commitment from the House leadership to move the bill, which currently has 113 co-sponsors, including 13 Democrats. Barton's comments follow a separate statement by House Speaker John Boehner (R-OH) expressing his support for lifting the 40-year ban.

On July 30, the Senate Committee on Energy and Natural Resources passed the Offshore Production and Energizing National Security Act of 2015. The OPENS Act would, among other things, authorize the export of any domestic crude oil or condensate without an export license (other than crude oil stored in the Strategic Petroleum Reserve) to countries not subject to sanctions by the United States. Although timing for Senate floor consideration is unclear at this point, the OPENS Act would likely require 60 affirmative votes for passage. For supporters of lifting the ban, the challenge of meeting that 60-vote threshold was underscored by the party line 12-10 vote in Committee.

In response to the Administration's action, Senate Energy Committee Chairman Lisa Murkowski (R-AK), issued a statement characterizing it as a positive step, but reiterated her commitment to "the full repeal of the ban on selling oil to our friends and allies overseas. . . as quickly as possible."

Conclusion

These recent developments demonstrate that further opportunities exist for companies to export crude oil from the United States. Today companies are open to pursue crude oil swaps with companies in Mexico in light of these recent approvals. However, obtaining a license for these transactions will require carefully structuring the transaction to meet the requisite regulatory framework while remaining commercially viable.

As noted, the legislative process surrounding the repeal of the crude oil export ban is also in full swing. Companies have the opportunity to engage in this process and potentially open markets even further.

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