PERSPECTIVES AND INSIGHTS:

# What Investors Should Know About Mexico's New Energy Law

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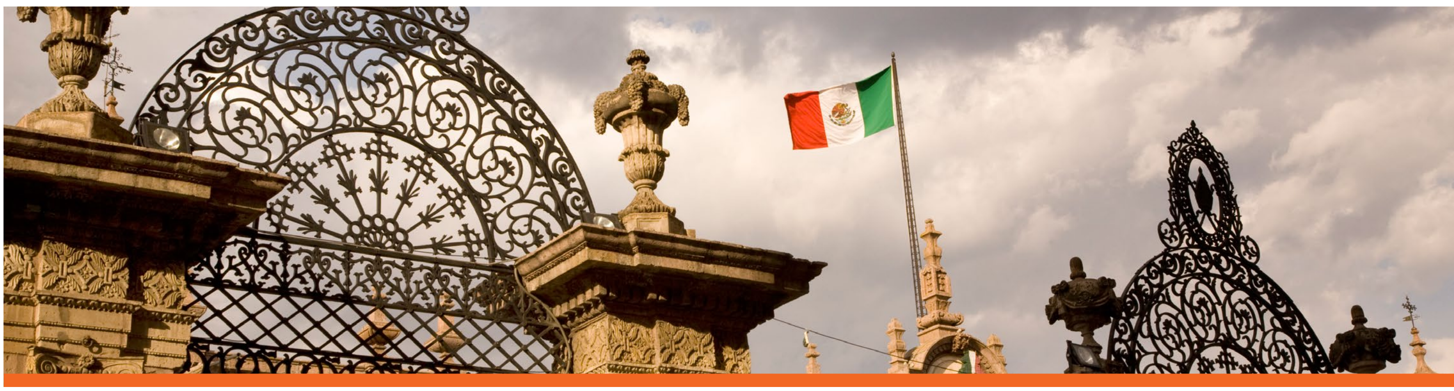

In December, Mexico's Congress passed a constitutional reform of Mexico's energy law. Within days, it was accepted by a majority of Mexico's 31 state legislatures (required for any constitutional amendment), and on December 21, 2013, President Enrique Peña Nieto signed it into law. This reform is a significant step toward permitting private capital to support Mexican oil and gas production, something that has not been permitted since the petroleum industry in Mexico was nationalized in 1938 by President Lázaro Cardenas, and has since then been a highly sensitive and political topic in Mexico. The reform does not allow oil and gas concessions, but it does allow private investment in oil and gas production through profit-sharing and/or production-sharing contracts and licenses.

After this historic change, Kroll asks Brian Weihs, Managing Director and Head of its Mexico office, about the future of the reform and its potential effects on private investment.

## Q. Why is the Mexican government open now to private investment in this market?

**A. The oil sector has long been critical to Mexico's economy.** Oil exports, even in more recent years, have generated some 10% of Mexico's export earnings and about a third of all tax revenues of the Mexican government. Oil production has declined significantly, however, since its peak in 2004, when Mexico was the world's fifth largest producer. At its peak oil production, Mexico produced almost 3.4 million barrels per day (mbpd). At the end of December, the country's National Commission of Hydrocarbons (CNH) estimated a little more than 2.5 mbpd.

While production of Mexico's most important oilfield, Cantarell, has declined, much of the new potential reserves are more difficult to access because they are in deep water or in shale formations (oil and gas). Pemex, the national oil company with a monopoly (until now) over oil production, has neither the technology nor the capital to adequately develop these more difficult resources; it has been able to drill only four exploratory wells. Private investment will be critical to tapping these resources and restoring Mexico to some of its former glory as a producer.

Also, given the potential reserves of deep water oil in Mexico's portion of the Gulf of Mexico, shale formations just south of the largest U.S. shale reserves, and other potential "tight oil" resources, there is a huge amount of interest in Mexico's oil and gas. Just the investment needed to develop these resources would be an important generator of economic activity.

## Q. How big is this potential new opportunity for investment? What kind of timetable is anticipated?

**A. It is hard to estimate the size of the potential market so soon after the constitutional reform.** Several experts, including BlackRock, the world's largest asset manager, have estimated that investment following the reform could add 1% to Mexico's GDP growth per year. Pemex recently announced that it intends to invest $28 billion this year, growing to $60 billion per year over the next few years.

The energy reform allows 180 days from its promulgation to draft the supporting legislation. Most companies are waiting to see that supporting legislation before deciding to invest. Given the amount of work to be done, the uncertainties around some of the concepts in the constitutional reform, and continuing opposition to the reform from some political sectors, the legislative timetable is likely to be extended. That said, everyone who supports the reform understands the urgency.

## Q. Who is opposed to private investment in the oil and gas industry?

**A. At the beginning of his term, President Peña Nieto managed to establish a pact among the three dominant parties in Mexico, known as the "Pact for Mexico," to negotiate several important reforms, including the energy reform.** This was key to the success in passing the energy reform, although in the end, one of the three parties, the leftist Revolutionary Democratic Party (PRD), walked out of the discussions and did not support the final reform. Between the ruling party, the Revolutionary Institutional Party (PRI), and the National Action Party (PAN), there were enough votes in the federal Congress to pass the reform. The surprise of the reform was that it ended up being farther-reaching than what was originally proposed by the PRI. It had to be, to win the support of the PAN. The PRD remains opposed to the reform and is pushing to take the reform to a popular referendum. It is looking to build a popular leftist front, including its former leader Andrés Manuel Lopez Obrador, a firebrand politician who still has a significant following in Mexico.

Following the dissatisfaction (and suspicion) of many Mexicans over the privatization of Mexican infrastructure in the early 1990s, such as the national telephone company, many remain very suspicious of this opening of the oil sector to private investment. The Pemex workers union will also lose considerable influence with the reform: one of the surprises of the reform was to remove the union representation from the Pemex board. Furthermore, workers of non-Pemex oil companies will be permitted to look to other unions to represent them. Added to this, there is still a national pride in state ownership of oil (in the ground) and oil production. Many Mexicans fear that the reform will lessen Mexico's sovereignty over this critical resource.

## Q. Will direct investment be allowed, or will it need to be in the form of a joint venture, partnership, etc., with a Mexican company?

**A. This is still an open question.** It is not clear how the various forms permitted for private investment will function, particularly the concept of licenses. Legislation will have to distinguish the license concept from that of a concession, the latter of which is explicitly not permitted under the constitution. At the same time, the government and legislators are well aware of investors' need to demonstrate asset growth (in the absence of ownership over oil and gas reserves) to be able to support their investment. Pemex will still have priority in a first round of production opportunities and will maintain its hold on the currently most productive fields, such as Cantarell and Ku-Maloob-Zaap, but it will need technology and capital to develop deeper and more complicated opportunities, and perhaps even to fully exploit its existing fields. There is also the question of how much domestic content will be required by law. Both legislation and practicality may require some form of joint venture with local companies, even if they are not necessarily with Pemex.

## Q. What are the top three challenges that investors will most likely face?

**A. The first challenge will be coming to terms with the continuing uncertainty of the reform and its implementing legislation.** At a constitutional level, there are still likely to be significant legal and political challenges to the reform. As I mentioned earlier, the PRD and other less formal political movements threaten to derail the reform. Second, once the legislative picture becomes clearer and the constitutional reform becomes more accepted (as I believe it will), companies will have to decide how best to structure their investments to minimize risk. The viability of production-sharing, profit-sharing, and particularly license arrangements, will depend a great deal on the details of the legislation and will not become clear until they are tried.

The third top challenge will be learning to invest and operate in Mexico's new oil and gas sector environment. With the long history of monopoly by Pemex, the sector is underdeveloped. There are few well-capitalized and well-qualified suppliers, and almost no local operators. There is a history in the Mexican oil and gas business of accusations of political interference, nepotism, influence-peddling, and fraudulent and corrupt business. There are also many areas of Mexico, particularly of interest to the oil and gas industries, which have complicated security situations. At the same time, the picture is quickly evolving. Several large Mexican multinationals, with success in other businesses like mining, construction, and engineering, are already maneuvering into this space. Former President Vicente Fox has spoken of an investment fund to finance the development of local players in this industry. It will be a huge challenge for foreign investors (and even high-level Mexican investors) to find their way in this new environment, to know whom they can work with and whom they cannot.

## Q. From a compliance standpoint, what are the potential pitfalls and how might investors prepare for them?

**A. From a compliance standpoint, Mexico is a challenging place to operate.** As in many emerging countries, there is very little transparency here in business structures or public decision-making, and there is a low level of public confidence in the judiciary. Mexico also suffers from a large informal sector, a significant presence of organized crime (mostly drug trafficking) and money laundering, and high perceived levels of public corruption. But none of this is new to any international company operating in Mexico. There is, however, growing scrutiny of compliance issues in Mexico, by both Mexican and foreign regulators, making the need for compliance that much more important to both foreign companies and large Mexican companies.

In the new oil and gas environment, there will be a few added challenges. Despite the reform, the partner in many oil and gas-related ventures will still be state-owned Pemex. Many of the private sector businesses around oil and gas include former Pemex people, people related to Pemex managers, and political interests. An important element of the energy reform will also be the restructuring of the roles of several state agencies—the regulators—resulting in new positions, powers, and interests within these agencies. These will include the CNH (mentioned above), the Commission for the Regulation of Energy (CRE), the National Center of Hydrocarbon Information (CNIH), the state revenue agency (SCHP), a national fund for managing oil and gas revenues, and a new agency for transporting and storing natural gas. Companies having to negotiate their way through the new powers of these and other related agencies (e.g., environmental) will face significant compliance challenges.

To do so effectively, companies will have to ensure that they have strong compliance structures and a good understanding of whom they are dealing with at all levels—partners, suppliers, agents, representatives, and the regulators themselves.

## Q. Are there "lessons learned" from similar investments in Latin America that investors can use to inform their strategies for Mexico?

**A. Numerous countries, both in Latin America and elsewhere, have been going through the process of opening their oil and gas industry to investment.**

Brazil is an interesting example of a country which went through a partial privatization of a national oil monopoly several years ago and has enjoyed a lot of anticipation regarding extensive deep-water resources, together with significant challenges in defining its regulatory framework and granting of concessions. The model is quite different, but there have been (and still are) questions about the role of the national oil company, the space permitted for private investment, national content, federal disputes over (anticipated) revenues, and a challenging political and compliance environment. Despite all of these challenges, committed international oil companies and service companies are operating successfully in Brazil. Most of them have had a long learning curve and have had to invest a great deal in understanding the environment and their partners and counterparts. This will doubtlessly be the case in Mexico as well.

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