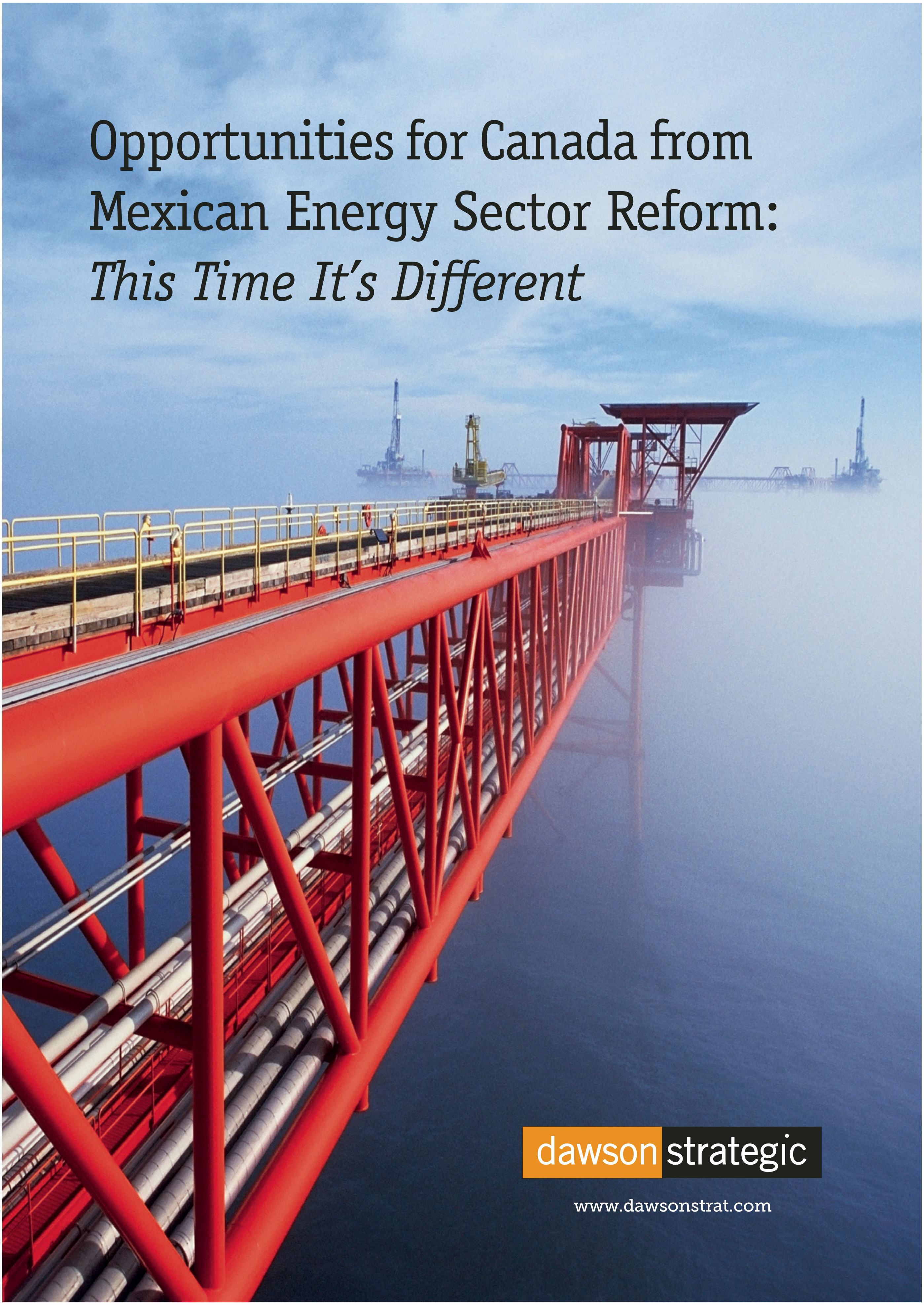
Opportunities for Canada from Mexican Energy Sector Reform: *This Time It's Different*



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Opportunities for Canada from Mexican Energy Sector Reform: *This Time It's Different*

By Jeffrey Phillips and Laura Dawson[1]

The Government of Mexico recently initiated a comprehensive reform package to open up and restore the profitability of its energy sector through an influx of foreign capital and technology. This briefing will cover the highlights of these reforms, the likely timeline for implementation and opportunities for Canadian companies.

Overview

On December 20, 2013, Mexican President Enrique Peña Nieto of the Partido Revolucionario Institucional (PRI) signed into law landmark energy reforms that will open up Mexico's hydrocarbons and electricity sectors to private investment. The reforms have received considerable attention in Mexican and foreign media and have been met with enthusiasm from the foreign investment community.

In total, the President's reform agenda includes changes to banking, education, telecommunications, competition, and tax collection. If implemented, the reforms will increase economic opportunities for Mexicans and build the country's stock of capital. As a trading partner, Mexico will become more stable and prosperous, yielding new opportunities for Canadian companies.

The changes to the energy sector are significant, requiring amendments to Articles 25, 27, and 28 of the national constitution and a large body of secondary legislation for implementation. The opening up of the oil and gas sector effectively ends a 75-year monopoly held by state-owned oil company Petróleos Mexicanos (PEMEX). Consequently, the reforms have been opposed by opposition parties and sparked public protests. This is not surprising given that the day in 1938 when President Lázaro Cárdenas ejected U.S. and British oil companies and nationalized Mexico's reserves is celebrated each year as a national holiday.[2]

In December 2013, only the broad strokes of the reforms were outlined, with the details to be provided in secondary legislation. The April 20, 2014 deadline for completing the secondary legislation was missed, but a package of 21 different laws was presented to Congress on April 30, 2014, the last day of the Congressional session. A special session of the legislature will now need to be held in the summer months in order to approve the legislation. The package of bills provides the long-awaited crucial details for key aspects of the reforms. On the whole, the secondary legislation assuages many of the concerns of foreign investors. It is clear that opportunities will open up in the medium-to long-term for Canadian companies across the oil and gas value chain.

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Highlights of the Reforms

- Constitutional reforms now allow profit- and production-sharing contracts, and licenses.
- Private companies will be allowed to invest in every stage of the value chain for the first time since the sector was nationalized in 1938. The introduction of new competition is planned on a gradual and selective basis.[3]
- PEMEX is being restructured into a productive state-owned company. The intention is to transform PEMEX from an inefficient monopoly to a more nimble company able to compete in the open market.

- The ownership and management of sub-surface hydrocarbons will remain with the Mexican state, and state regulatory agencies will have greater powers for effective oversight of domestic and foreign companies in the market.

As a productive state-owned company capable of competing in the marketplace, PEMEX's main objective will be "creating economic value and increasing the Nation's revenue following the principles of equity, and social and environmental responsibility."[4] The budget for PEMEX would be proposed by the Ministry of Finance and approved by Congress.

Highlights of the Secondary Legislation

- The package of bills contains 13 amendments to existing secondary legislation as well as 8 new laws.
- Local content – a 25 percent target for national content in energy projects to be achieved by 2025. The content will vary on a case-by-case basis.
- Trans-boundary exploration and production (E&P) projects – the private sector will be required to include PEMEX for a minimum interest of 20%.
- Regulatory – budgetary autonomy for the independent regulators, the CNH and the CRE. A new environmental protection agency will be created named the National Agency for Industrial Security and Environmental Protection in the Hydrocarbon Sector.[5]
- PEMEX – to have more financial and operational freedom. The tax rate for PEMEX will be reduced from 79 percent to 65 percent overall.
- The contract terms for E&P projects are not detailed. However, there is a provision that in the event of a tie between bids from national and a foreign company for an E&P contract, preference will be given to the Mexican firm.
- Taxes – two new taxes have been proposed: the Hydrocarbons Income Law and the Mexican Petroleum Fund for the Stabilization and Development Act.[6]

Contracts and the New Regulatory Framework

Mexico's National Hydrocarbon Commission (CNH) will be able to award four different types of contracts to private companies, foreign or domestic: 1) service contracts; 2) profit-sharing; 3) production-sharing; and 4) licenses.[7] Reserves remain the property of the state while still in the ground. Mexican officials advise that new players will be able to record Mexican reserves as future benefits in notes to their financial statements, but cannot claim them as assets.[8]

The reforms will create new, independent regulators for licensing, safety, and environmental protection, and Mexico's regulatory agencies will operate with more autonomy and authority.[9]

Figure 1: Structure of the new regulatory framework

CABINET LEVEL DEPARTMENTS		
Ministry of Finance and Public Credit – SHCP In charge of bids and contracts guidelines	**Ministry of Energy – SENER** Sets general energy policy and determines with CNH which fields to open to bid in each round	**Ministry of Environment and Natural Resources – SEMARNAT** Determines environmental and industry safety through new agency

INDEPENDENT REGULATORS	OPERATING COMPANIES
National Hydrocarbons Commission – CNH Regulates upstream activities and determines winners of upstream bids	**Petróleos Mexicanos – PEMEX** A productive enterprise of the state focused on oil and gas
Energy Regulatory Commission – CRE Regulates electricity and mid- and downstream for hydrocarbons	**Comisión Federal de Electricidad – CFE** A productive enterprise of the state focused on electricity

Source: O'Neil, Shannon. 19 March 2014. 'A Primer: Mexico Energy Reforms.' Vianovo. Available at: http://vianovo.com/news/a-primer-mexico-energy-reforms

Figure 2: Timeline of Mexico's Energy Reforms

President Nieto proposes an overhaul of Mexico's energy industry to allow private companies profit-sharing contracts

Congress begins to draft and debate secondary laws

Secondary legislation is presented to Congress as a package of 21 bills

Mexican government plans to hold a first tender round by this time. PEMEX would compete equally alongside foreign companies.

Mexico's three main political parties sign the *Pacto por México*, an agreement that seeks to accomplish a broad set of reforms (e.g. education, energy, security) previously obstructed by political gridlock

President Nieto signs into law the reforms to the energy sector. The Bill calls for amendments to Articles 25, 27, and 28 of the national Constitution and adds 21 'transitional articles' outlining the regulations to be implemented

PEMEX provides the energy ministry with a list of upstream assets that it wants to keep as part of the "Round Zero" process.

The *Secretaría de Energía* (Ministry of Energy) and the *Comisión Nacional de Hidrocarburos* (CNH – the Hydrocarbons Commission) will rule on PEMEX proposals.

Sources: Reuters (2014); Mayer-Brown (2013); BBVA (2014); O'Neil (2014).

Rationale and Benefits

Mexico is a large but not particularly efficient producer of crude oil. Ranking as the world's 12th largest producer and 12th largest exporter, about half of Mexico's oil is exported, mostly to the United States. PEMEX is currently the only company authorized to conduct exploration and development in the oil and gas sector.

Over the past eight years, crude oil production has decreased by a million barrels per day despite record levels of investment. PEMEX is unable to satisfy demand for gasoline and diesel and Mexico must import 49 percent of its domestic production (as well as 65 percent of its petrochemicals and 33 percent of its natural gas). Inefficiencies in the energy sector diminish Mexico's export returns and make energy-intensive manufacturing unprofitable. Thus, the need for reform is clear.

The energy sector reforms are expected to create substantial economic benefits for Mexico and North America. Shortly after the reforms were signed into law in December 2013, Standard & Poor's raised its sovereign long-term foreign currency credit rating up a notch to BBB-plus, a signal of confidence in the direction of the reforms.

The Mexican government expects:

- The creation of half a million jobs by 2018 and 2.5 million jobs by 2025;
- An additional one percent in GDP growth by 2018 and two percent by 2025;
- An increase in oil production from the current 2.5 million bpd to 3.5 million in 2025; and
- Lower costs of electricity and gasoline.

The U.S. bank BBVA Compass forecasts that the multiplier effect from energy investments spurred by the reforms will generate $1.2 trillion in economic activity in the Texas-North Mexico region over the next 10 years.[10]

Opportunities for Canadians

Most of the early excitement around project opportunities focused on Mexico's substantial deep-water and shale resources, since PEMEX lacks the necessary technology and capital to develop such resources on its own.

However, Canadian companies are well situated to capitalize on opportunities in the mid-stream and downstream areas, in particular pipeline infrastructure. Ancillary to the reforms, demand for natural gas in Mexico is increasing and expected to double by 2025, but the country lacks the necessary distribution infrastructure to move the gas to where it is needed most. This is one reason why natural gas is so expensive in Mexico. Affordable gas could provide an important boost to Mexico's manufacturing and transportation sectors. According to Mexican energy specialist Rashide Assad Atala:

> One big reform that should have happened a long time ago, but has not happened yet [is] building infrastructure to connect the U.S. gas industry to the Mexican one.[11]

Although U.S. companies will likely be the first to gain, Mexico is not a new market for Canadian companies. They have been active in areas such as geophysical services and mapping, drilling and support services, pipelines, and field machinery and equipment. Export Development Canada estimates that are currently around 85 Canadian companies operating in the Mexican oil and gas sector.

TransCanada, for example, has been in Mexico since the mid-1990s, and their active pipeline projects are increasing as the country seeks to connect supply of natural gas to demand markets. TransCanada predicts that its investment in Mexico will rise to approximately $2.6 billion by the end of 2016.[12]

In the service sector, Canadian companies could provide:

- Technologies for hydraulic fracturing and horizontal drilling, and well-services (monitoring, controlling and automation);
- Technologies for secondary and enhanced oil recovery processes;[13]
- Products and services for inspection, maintenance and repair of pipelines; and
- Marine services related to offshore oil and gas production (e.g. supply ships, dynamic positioning vessels, and shipyards).

The Continental Perspective

A reversal of declining Mexican oil production would contribute to North American capacity as a whole and bolster continental energy security and stability. North America could consolidate its status as an energy bloc and generate spin-off benefits in manufacturing and industrial competitiveness.[14] This comes at a time when Mexico is already on track to overtake Japan and Canada as the number one source of imported cars to the United States by the end of 2015.[15]

Of course, further down the road Mexico and Canada could find themselves competing to supply the United States with oil and natural gas, but this market will require increasingly less product from either country because of booming domestic production.

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The timeline for moving the reforms forward is ambitious by any political calendar. It is prudent to recognize that there are real obstacles to future progress, including:

- The fiscal and institutional capacity of Mexico – still very much a developing country – to successfully coordinate and implement the proposed reforms.
- Mexico's ongoing challenges with violence, corruption, and rule of law.[16]
- The debates between the business-oriented President and political opposition over the government's right to open up Mexico's energy patrimony to foreigners.
- The ability of the government to manage the expectations of foreign investors regarding the speed and efficacy and reforms, while still maintaining investor confidence that this time it will be different.

Nonetheless, real progress is being made and delegations of top business leaders from the United States continue to meet regularly with Mexican officials. The time is ripe for Canadians to also consider the development and diversification opportunities that Mexico has to offer.

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1 The authors are grateful for the contributions of Jeremy Martin and Alexis Arthur (Institute of the Americas), and Alexandre Cérat, (Canadian Embassy in Mexico).

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