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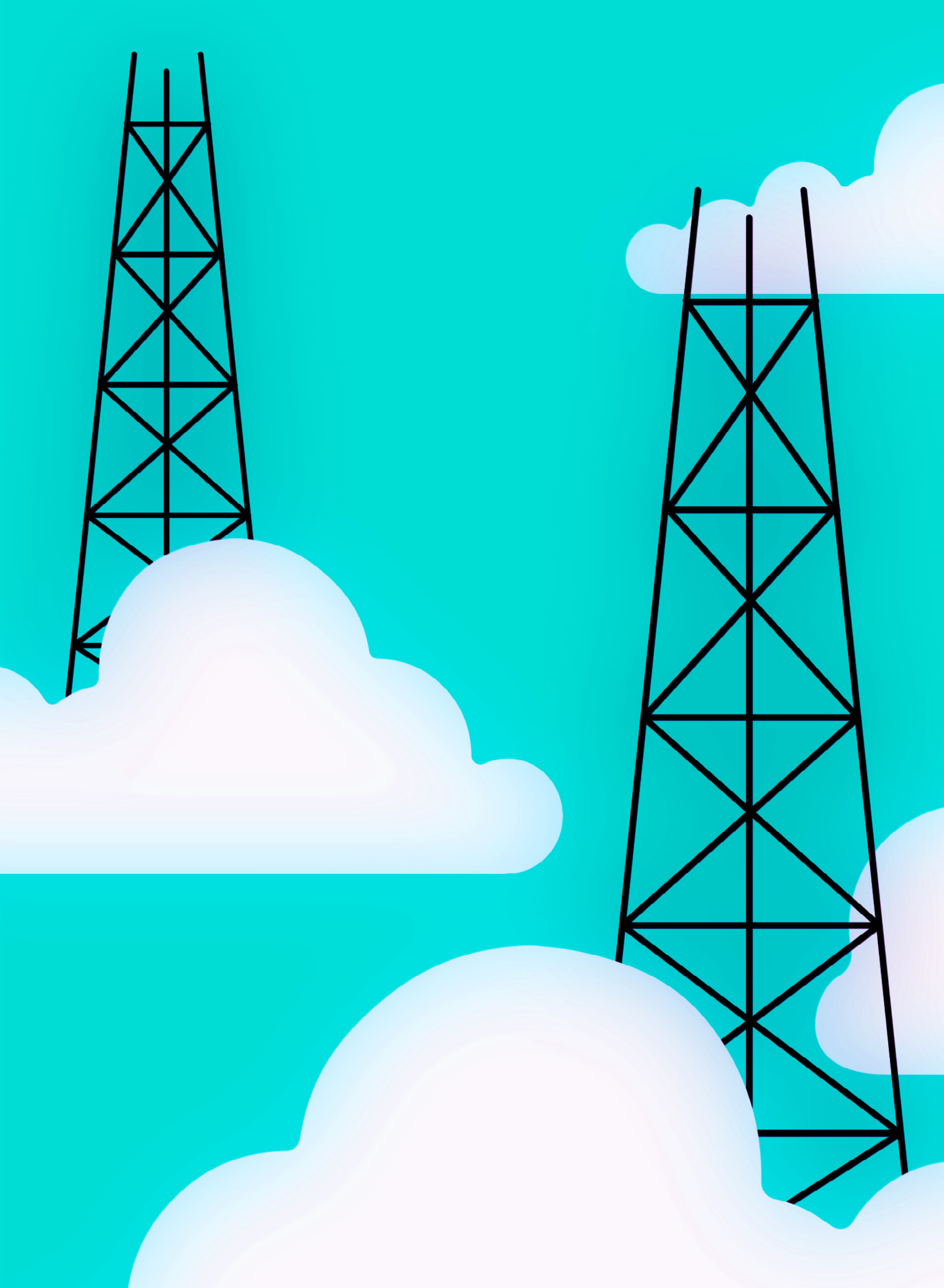
Mexico's Oilfields of Dreams



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By opening up its oil and gas reserves to foreign investment, Mexico hopes to boost production and GDP. Foreign energy companies and investors hope to profit from new, rich and logistically convenient sources of gas and oil. For everyone's dreams to come true, Mexico will have to implement its reforms fairly and openly, and investors will have to learn the rules and how to play in a very challenging environment.

Mexico's sweeping energy reform bill that was passed in December 2013 has created an extraordinary opportunity for Mexico and for the global energy community. The North American energy sector has greeted the reform with understandable excitement. The new policy will open up to foreign investment vast new oil and gas deposits both onshore and in the Gulf of Mexico. These resources are physically close to the United States, limiting the logistic challenges of extraction and distribution, and the path to profitability already has been smoothed by the strong trade ties sealed under the North American Free Trade Agreement passed two decades ago.

Mexico's oil and gas reserves have been dominated for 75 years by Petróleos Mexicanos, or Pemex, the national petroleum monopoly established when the country nationalized its oil industry in 1938, just as its electric power generation capabilities has been dominated by the Comisión Federal de Electricidad (CFE) since 1937. Pemex, the world's fifth-largest oil company by sales, pays almost 100 percent of its pre-tax revenues to the government ($69 billion in 2012) and accounts for approximately one-third of the federal budget.

Unfortunately, despite or because of its long-standing monopoly, Pemex's operations have persistently been characterized by inefficiency and accused of corruption. Mexico's oil production has declined in recent years to 2.936 million barrels per day in 2012, down from a peak of 3.5 million barrels per day in 2007, a drop of 16 percent. And Pemex has lacked the capital and expertise to explore offshore deposits in the Gulf or in its onshore gas fields that require hydraulic fracturing to exploit. These are among the factors that drove the Mexican government, led by President Enrique Peña Nieto, to prepare the legislation that rolls back nearly eight decades of history and allows private investment in natural resources believed by many Mexicans to be a national birthright. The government recognized that investment and technology were needed to access the oil and gas reserves and to build a modern infrastructure to exploit them.

The energy reform also includes provisions to open up the country's electricity market by establishing the National Center for Energy Control, designed to create competition between the state-owned CFE and private firms in an open, wholesale energy trading market.

The anticipated economic benefits of the reform are significant. The Mexican government forecasts major increases in both oil and natural gas production over the next decade, with oil production projected to rise by 3 million barrels of oil per day by 2018, creating 2.5 million new jobs during that period. Economists see a corresponding 4 percent rise in gross domestic product growth by 2018.

The Fine Print

Mexico's plans to open up the oil market, attract foreign investment, and boost production and economic growth have made global headlines, but the details of how the government plans to make the reform work are not so clear or accessible. Especially important are the set of laws known as enabling legislation, or secondary legislation, due to be enacted in this session of the National Congress or perhaps in an extra session. These laws will provide the rules under which industry players will be allowed to explore, drill and extract oil and gas onshore and in the Gulf of Mexico and also will lay out regulations for the bidding process that companies will need to follow to win contracts. The exact language in the laws will give corporate managers important perceptions into the level of risk at stake, which will aid in evaluating investment options in the Mexican oil market — risks that reflect the realities of life and business in Mexico today.

As information about the secondary legislation comes into focus, decision makers will have to assess the provisions in light of a company's appetite for risk. In addition, executives will have to familiarize themselves with influential policymakers, government institutions and other factors that should enter into risk management calculations. Other factors include political opposition; corruption and the government's response to it; potential changes in national leadership; national, regional and local business climate; and the violence associated with drug cartels in cartel-controlled areas.

This article's intent is to provide timely insights for executives evaluating the opportunities in Mexico's energy market. Note, also, that the principles for strategic assessments of risk; stakeholder engagement approaches; and situational awareness of the national, regional and local environment discussed here apply to other fast-moving, emerging markets where management must weigh risks and rewards in the context of the company's capabilities and strategic vision.

Assessing Risks: The Laws, the Players and the Political Environment

While it's unlikely that any one part of the secondary legislation will be enough to constitute a barrier to investment, each element that emerges will create a risk to manage, mitigate or accept. For example, the reform allows for four basic types of contracts related to oil and gas exploration and exploitation:

- Services contract (which existed under prior Mexican law)
- Profit sharing
- Production sharing
- License

Combinations of these instruments also are permitted. The secondary legislation will provide rules for granting contracts and licenses to private parties, including foreign companies, for all downstream activities such as refining, pipelines, petrochemicals production, transport and management of gas stations.

The new laws will determine which type of contract will correspond to each of these commercial activities or will authorize the government to decide the type of contract (such as a services contract or a license) for each activity. Two agencies — the Ministry of Energy and the National Hydrocarbons Commission — will be central to the process of granting contracts and licenses. The reform bill calls for the Ministry of Energy to determine which geographic areas are open to exploration and extraction and authorizes the Hydrocarbons Commission to organize the bidding process, select the winners, subscribe the contracts and provide technical support. The secondary legislation will establish details about how these two government institutions will coordinate their activities.

In evaluating sections of the secondary legislation that emerge, decision makers should look for these elements:

PROVISIONS THAT ENSURE A COMPETITIVE MARKET.

The enabling legislation needs to guarantee that Pemex and the Federal Electricity Commission, which is also included in this reform, become competitive companies in a market open to new players.

BIDDING PROCESS THAT SEEKS TO MAXIMIZE RETURNS.

Tender processes must guarantee the highest oil revenues by requiring all bidders (including Pemex when it participates) to compete for contracts on terms such as work quality, cost, efficiency and the capacity to offer a return to the Mexican government. This will demonstrate that the rules to open the market will align all players' interests — including new entrants and the Mexican government — around a common revenue-maximizing goal.

NEW GOVERNMENT INSTITUTIONS THAT ARE TRANSPARENT.

The energy reform bill created four important agencies:

1. Mexican Oil Fund, a sovereign fund to administer and invest oil revenues.
2. National Center of Natural Gas Control, which will govern the operation of gas pipelines.
3. National Center of Energy Control, which will oversee the national electricity system.
4. National Agency for Industrial Safety and Environmental Protection, which will oversee environmental compliance.

The secondary legislation should include provisions to ensure that these new authorities make decisions that are disclosed to all players in the market.

CLEAR LANGUAGE THAT DEMONSTRATES A COMMITMENT TO THE RULE OF LAW.

Decision makers should look for language in the secondary legislation that establishes clear and permanent rules, with a framework for enforcement that is not arbitrary and cannot be manipulated in favor of an individual or group (such as one with political ties).

The market itself will provide metrics to determine the success of Mexico's energy reform. The rate of participation from industry players from around the globe, including their forming successful partnerships with private Mexican energy firms, will be an early indicator of how reform is being received. Other signals include indications of a transparent bidding process, degree of investment, and improved production and environmental practices. Because the energy reform bill gives Pemex the right to retain fields as long as it shows the Ministry of Energy that the monopoly has the financial and technical resources to develop these resources, the fortunes of the national oil company also will be a success indicator. If Pemex begins to operate abroad, as do the Malaysian and Colombian state-owned oil enterprises, that will signal real progress.

The Political Climate and Additional Risk Factors

Over the short term, there is a very small chance that internal opposition to Mexico's energy reform could derail the law or the secondary legislation from going forward — and bears watching. A social movement opposing the reform is trying to arrange a public consultation, a kind of referendum allowed under the Mexican Constitution to reverse the reform. Such a referendum, if it comes to pass, would not happen before 2015 and would be binding only if 44 percent

THE PLAYERS

In Mexico, President Enrique Peña Nieto clearly is spearheading energy reform, the centerpiece in an array of sweeping changes designed to spur economic growth. But he is not acting alone. Some of the key players and agencies are:

FINANCE MINISTER
Luis Videgaray Caso

An able economist, Luis Videgaray Caso has been part of President Peña Nieto's circle of advisors for almost a decade and is entrusted with both guiding the economy and bringing about widespread changes in economic policy. Specifically, the Finance Minister is playing an active role in energy reform. This past February, he said the government will sign its first contract with private companies by February 2015, an important signal to market watchers. It is not yet clear which companies will participate.

ENERGY MINISTER
Pedro Joaquín Coldwell

Pedro Joaquín Coldwell holds the key post of Energy Minister, bringing to this position more than four decades of experience in politics and government, which should serve him well in helping guide the energy sector through this major transition. One of the goals of the reform is to strengthen the role of the Energy Ministry.

PEMEX DIRECTOR GENERAL
Emilio Lozoya Austin

As the head of Pemex, Emilio Lozoya Austin will carry out the critical role of transforming Pemex from a slow-moving monopoly to a transparent, productive and efficient modern oil company.

ENERGY REGULATORY COMMISSION

Founded more than 15 years ago under the Ministry of Energy, this five-member commission operates autonomously, regulates the energy sector and will play a crucial role in defining the new regulations. The commission also will grant permits for storage, transportation and distribution of hydrocarbons through pipelines. It will regulate access of third parties to that infrastructure. And the agency will grant permits for electricity generation and control the prices for electricity transmission and distribution.

NATIONAL HYDROCARBONS COMMISSION

The agency will organize the bidding process for oil exploration, select the winners and oversee the contracts. It will authorize surface and other studies, supervise production plans and provide technical assistance to the Ministry of Energy.

of the registered electorate participates. But even if these conditions are met, a reversal is unlikely because Mexico's Supreme Court still would need to determine if energy reform is subject to the consultation process.

Signs of corruption represent a more significant risk. Corruption scandals are not uncommon in Mexico, and a spate of them tied to energy reform could slow the progress of reform or negatively affect its implementation. Mexico's public sector, for example, is ranked 106 out of 177 countries in the Transparency International 2013 Corruption Perceptions Index. But there's encouraging evidence of a climate and policy shift. A recent scandal involving Oceanografia, a preferred Pemex supplier, exposed shady contracts and allegations of fraud. The subsequent announcement of an immediate government takeover of the oil services firm represented a serious response. How the government and Pemex ultimately unwind the Oceanografia crisis could provide additional signals to investors.

Finally, some of the country's richest shale gas reserves are located in areas that touch the Burgos Field region such as Nuevo León, Coahuila and Tamaulipas, as well as Chihuahua and Veracruz, where drug trafficking and organized crime gangs operate. Besides the risk of violence, companies face the risk of bribery and demands for facilitation payments that make doing business difficult without violating a company's own internal controls or running afoul of regulations such as the U.S. Foreign Corrupt Practices Act and the UK Bribery Act.

Strategic Communications Advice

Pursuing investments in the Mexican market requires that companies establish a stakeholder engagement strategy that positions the company as a preferred partner in a rapidly evolving energy sector that has enormous potential. Corporate communications strategists should tailor their engagement strategy to the specific context of Mexican market reform and would be wise to familiarize themselves with key policymakers and business leaders (see "The Players," page 4). Companies must be prepared to:

- Build relationships with key individuals and institutions that will frame, regulate and implement the energy sector reforms.
- Engage on an individual basis with people whose information and insights will help guide a company in its engagement plan on issues such as timetables, criteria, and current thinking at Pemex and in the government.
- Undertake a political risk assessment to understand the potential for disruptions from events such as policymaker changes or the constitutional consultation process.
- Closely track and understand the secondary legislation now under development and the process for producing it.
- Monitor competitors' strategies and ongoing activities to gauge how the reform is playing out.
- Prepare a detailed strategy and implementation plan and specify whether the company is interested in Mexico's offshore or onshore and oil or gas resources.

The Mexican market represents a great opportunity for North American and other oil and gas players to invest and expand in a rich market long barred to them. Entering this market successfully, with eyes wide open, demands a detailed understanding of the historic reforms designed to unlock the markets to investors. When a country opens doors that have been closed for decades, there's sure to be a crowd jostling to get in. It would be wise to know what awaits on the other side before crossing the threshold.

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