# Mexico's Energy Reform

## Upstream: Opportunities & challenges

### Secondary laws of Mexico's Energy Reform. Making the reforms real.

**Background (Drivers for change in Mexico's oil and gas market)**

Mexico has significant oil and gas reserves, yet in the past few years its oil production has declined 25 percent to 2.5 million barrels per day (bbl/d) from a peak of 3.3 million bbl/d in 2004. Mexico's state-owned oil company, Petróleos Mexicanos' (PEMEX) production will continue to fall, dropping below 2.4 million bbl/d in 2015, the second-lowest production rate in 29 years.[1] At the same time, the decline of Mexico's natural gas production has forced the country to import about 40 percent of the gas it uses.[2]

Mexico's oil and gas industry looks promising for the country and for those players able to accelerate their entry into Mexico's energy market.

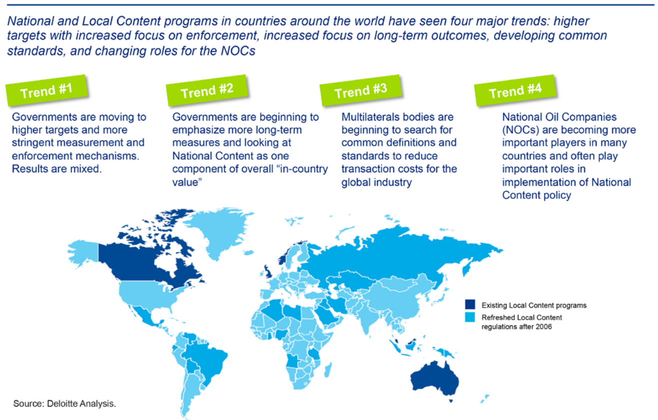
Previous efforts to open Mexico's exploration and production did not create enough incentives to attract independent oil companies. This lack of outside investment, combined with declining production and increased expected demand growth, has created a looming supply-demand balance crisis. In December 2013, after years of contentious deliberations, the Mexican government amended the Constitution, opening the oil and gas market[3] to private foreign and local investors for the first time since 1938.

In August 2014, the Mexican congress approved secondary laws that clarified the steps needed to transition opportunities to reality. These laws provide additional detail on several aspects of the reform. Some remaining ambiguity should be clarified with additional legislation that will be enacted in the next few months. This legislation should define more granularity into the interpretation and administration of the laws.

1 Excelsior, "Cubrirán con deuda redución petrolera," Sept 9, 2014
2 Deloitte, "Mexican energy reform: Opportunity Knocks," 2014
3 With the exception of natural gas transport and storage that will be handled by CENAGAS

While the reform has broad implications for all aspects of the oil and gas industry, we will focus on the opportunities and challenges in the exploration and production (E&P) sector. With the adoption of secondary energy reform legislation, the Mexican government offers a clearer picture of how it will implement reforms.

### Major global trends in national and local content



Source: Deloitte Analysis.

### Secondary laws and the assignment process

Under the secondary laws, Mexico's National Hydrocarbon Commission (Comisión Nacional de Hidrocarburos or CNH) either assigns an oilfield to PEMEX, or any other "state productive company" through a process known as "asignación," or it will award the field to a third party. The third party can explore and extract hydrocarbons under a separate contract known as a "Contrato para Exploración y Extracción." These assignments and contracts will be awarded in several stages known as "the rounds."

## Assignment rounds have generated interest from players but no blocks have been awarded yet.

In the first round, known as "round zero," the CNH assigned the Grijalva, Ayin-Aux, Caan, Cardenas, Tamaulipas-Constituciones, and Ek-Balam[4] fields to PEMEX. It will oversee these "asignaciones" and make sure PEMEX delivers on its commitments. PEMEX, in turn, can subcontract services with third parties to fulfill its commitment, although opportunities for third parties to participate in production-sharing with PEMEX are limited.

On the other hand, the current round—officially "round one"—may present more lucrative opportunities for third parties. That round will open 169 deepwater blocks with potential for both conventional and unconventional plays.

The blocks comprise a total area of 28,500 square kilometers with 14,606 million barrels equivalent (MMboe) of proven reserves and 3,782 MMboe of probable reserves.

While round one represents the first chance for outside companies to participate in Mexico's oilfields, no blocks have been assigned to third parties yet. Although the contracts for round one should be awarded this summer, the recent precipitous drop in oil prices will have an effect on the interests of third parties to actively participate in Mexico. At a minimum, projects may be delayed or time lines may be adjusted. The Mexican government may also find their revenues from these initial blocks to be lower, based on revised economics. Long term softness will undoubtedly change the Mexican energy landscape.

### Implementation challenges

The reforming process does not end with the approval of legislation. Implementing the changes will be the most critical phase for Mexico's energy reform.

#### Country challenges

Mexican authorities face a series of challenges in implementing the reform and the secondary laws. First, they must understand the importance of creating detailed contracts that are clear and attractive enough for foreign oil companies to participate in this venture.[4,5]

Second, the industry will require infrastructure, especially in places where it is scarce. Mexico's government will have to build roads and facilities, provide public services, and ensure public safety. Moreover, an efficient management of the "open access" policy providing transport and distribution services for all E&P companies will be crucial.

#### Challenges for new market entrants

The passing of the secondary laws opens the door for foreign investment in the oil and gas sector, but more must be done to clarify the process. New regulations, guidelines, criteria and other actions are still needed. The challenges facing new entrants can be grouped into three major categories: a) compliance with legal, tax, sustainability, financial, and other obligations; b) extreme market competition; and c) establishing operations in the Mexican market.

4 www.energylegalblog.com/archives/2014/08/18/5779#sthash. SJ0WKAPc.dpuf

5 Oilandgasmagazine.com.mx/2014/08/ contratos-la-clave-del-exito-para-el-nuevo- pemex/?relatedposts_hit=1&relatedposts_origin=4170&relatedposts_position=0#sthash.vuuJ19mw.dpuf

### A. Compliance with legal, tax, sustainability, financial, and other obligations

The secondary laws contain hundreds of pages that still must be translated into regulations. New entrants must quickly understand and adapt to all aspects of Mexico's regulatory framework, including legal requirements, tax laws and environmental regulations. They also will need to seek local advice because the reform laws require that all legal disputes be handled in Mexico under Mexican law.

In addition, companies must comply with financial reporting requirements under Mexico's accounting regulations, and they must have a strong understanding of payment mechanisms, such as royalties and licenses, assigned to each contract type.

Finally, compliance with national content regulations is critical not just from a legal standpoint, but also for addressing concerns of local residents who may have opposed the reforms. The law requires that at least 25 percent of hydrocarbon exploration and extraction be provided by local companies in 2015, rising to 35 percent by 2025. The government will review the rules every five years after that. The 35 percent threshold excludes deepwater projects, but the Mexican government has reserved the right to set local content regulations for deepwater and ultra deepwater projects later.

### B. Market competition

Mexico's reforms have attracted the attention of investors worldwide. Initial estimates indicate that as much as $8.53 billion per annum could flow into the country from foreign sources between 2015 and 2018.

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Challenges are considerable and companies will need to quickly adapt to Mexico's environment to better seize opportunities generated by the reform.

New market entrants should be prepared for the round one bids, which will require experience in Mexico's tendering processes to present a compelling proposal. A company that lands a contract also must engage in direct negotiations with land owners for the use of their land. The Agrarian Attorney's Office (Procuraduría Agraria) may intervene to ensure fairness, which could affect both timelines and profits for participants.

Furthermore, new market entrants must understand the competitive landscape in Mexico's energy market to identify both; competition and potential local partners. The correct selection of partners and strategic alliances could have a tremendous impact on the set-up of the company in the country, its supply and value chain, and thus its future success.

### C. Operations set-up—landing in the Mexican market

Entering a new market presents challenges, ranging from a country's unique regulatory requirements to operational challenges in the day-to-day business. Some of the challenges an entrant should consider are:

- Understanding the true potential of the market and defining an entrance strategy, which includes:
  - Defining the potential for the company's core business and the proper timing according to current and pending legislation
  - Defining a strategy to enter into Mexico's energy market, such as joint-ventures, mergers and acquisitions
- Determining the activities that are essential to the business and those that can be outsourced. In addition, companies may need to redesign operational processes to adapt to the Mexican market, which includes complying with local content provisions.
- Selection of, and implementation of, the proper processes, IT systems, suppliers, and organizational design.
- Recognition of the scarcity of well-trained personnel in Mexico's oil and gas sector. This issue will take years to resolve
- Although global energy giants may be able to fund many of their own projects for others, project financing may require companies to tap the capital markets, including local financial institutions in Mexico.

In brief, while during the past 18 months the Mexican government has demonstrated a deep commitment to transforming its energy industry, many questions still remain unanswered. Mexico has been faster at implementing its reforms than at any time since the industry was nationalized in 1938. As a final point, while in the short term, the precipitous drop in oil prices will clearly have an effect on the success of the reform, the drop is an opportunity for all parties to reaffirm their commitments to change, make course corrections, and move forward.

We don't know what the final Mexico E&P landscape will look like but it is clear it will not look anything like it does today. For companies that want to participate in these changes, being prepared, understanding Mexico's business environment, and picking good partners will be key.

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