

## Mexican energy reform Privatization creates new opportunities and prospects



Mexico is experiencing a historic shift in its energy sector, primarily due to 2013 legislation that allows private investment in the Oil & Gas industry. This shift creates unprecedented new opportunities for foreign investment that flow throughout the entire Oil and Gas value chain. And while falling oil prices may mitigate some of the short-term benefits, international companies and investors are likely to see favorable investment opportunities thanks to low production costs and long-term access to the region.

Over the next few years, the Mexican government will likely decide who has rights to upstream opportunities through a series of auction rounds, making this a critical time for international investors to seek Mexican partners and consider their options. Also, important new opportunities may arise for international midstream providers. The legislation will likely allow private companies to directly transport and store oil and gas (and derived products), set up refineries and process and sell petrochemical products within the country, creating a market less reliant on imports of natural gas and refined products.

This article aims to provide insights on the current state of the Mexican energy reforms and explore investment opportunities across the Oil & Gas value chain in greater depth.

### History and timing of legislative changes

While Mexico is rich in oil potential, oil production has declined by about 25%<sup>1</sup> over the past decade, in part due to outdated domestic technology and lack of investment in new exploration. With the December 2013 legislation ending the 75-year-old monopoly of state-owned Petroleos Mexicanos (PEMEX), the Mexican government has formally acknowledged its need for foreign partners and investors. While the investment levels and associated impact are still unfolding, it appears that outsiders are optimistic that the changes will take root. Subsequent legislation in 2014 to ease reform implementation prompted the U.S. Energy Information Administration (EIA) to revise its 2040 forecast for Mexican production up by 76%<sup>2</sup>.

Unconventional resources offer another potential area for foreign investment in Mexico. Over the next few years, the Mexican government will likely assign contracts for the exploration and extraction of shale hydrocarbons via auction of the many relatively new and unexplored fields. The partnerships that these contracts foster can help Mexico extract its conventional and unconventional resources that would be difficult if not impossible to access without international expertise.

In tandem with the opportunities that upstream players face with the reform, the demand for midstream service

activities involved in the Oil & Gas value chain, such as the development of pipeline projects, is also likely to grow.

Initial estimates of the economic benefits that these auctions could create for Mexico were high, with the government estimating more than US\$50<sup>3</sup> billion in proceeds over the four years from 2015 to 2018 and a 2%<sup>4</sup> increase in Mexican GDP over 10 years. Lower oil prices may threaten such outcomes, as well as Mexico's overall economic situation, since oil revenues represent approximately 30% of fiscal revenue and approximately 10% of total export revenue<sup>5</sup>. For international Oil and Gas companies, however, the opportunities are likely to remain strong. Given that production costs are relatively low, ranging around US\$20 per barrel<sup>6</sup> in the shallow water fields, industry experts expect that extracting oil in the Gulf of Mexico will be profitable as long as oil prices do not fall below production costs. To the extent that oil prices do not fall below this level, the energy reform is still likely to attract foreign investment.

One sign of the Mexican government's commitment to reforms is that based on the legislation, five regulatory bodies – some new, and some newly-empowered - will oversee the energy market in Mexico to promote transparency and efficiency. These include the Ministry of Energy (SENER), the Ministry of Finance and Public Credit (SHCP), the National Hydrocarbons Commission (CNH), the Energy Regulatory Commission (CRE), and the National Center.

### M&A Market Opportunities for Midstream Players

While opportunities for upstream Oil and Gas players are perhaps the most obvious, midstream and downstream players should consider preparing themselves to capitalize on the reforms. The following factors may also spur the need for international partners and investors:

- The opening of midstream and downstream opportunities is likely to result in an increase in refined products and petrochemicals production regionally, potentially creating a need to improve logistical activities such as transport and distribution and to increase storage capacity.
- Housing, water, pipeline, and waste management infrastructure may also need to expand to facilitate development across the entire value chain. Some observers have predicted around US\$34 billion or more in pipeline investment will be required over the next several years to transport growing production <sup>7</sup>.
- General consensus indicates one of the key areas of foreign investment will be the gas pipeline sector (midstream), as the current pipeline infrastructure is not sufficient to meet consumer gas requirements.<sup>8</sup>
- Increases in Exploration and Production (E&P), both onshore and offshore, may require a substantial expansion of the supply chain for related equipment and materials.
- The new demand for oil field services in Mexico could drive M&A activities where international competitors join local players. The advanced technologies and more complete set of services that international players offer, combined with the domestic experience of local providers, can help companies looking to invest in Mexico differentiate themselves.
- Unconventional resource development can also necessitate substantial investment in roads. This is evident in the Texas Eagle Ford shale, where rural county roads have deteriorated rapidly under the strain of heavy truck traffic. Significant opportunities may exist in the planning, financing, and construction of the requisite road infrastructure needed to support additional Oil and Gas development.

In all of these areas, Mexican authorities can look to two main sources for partners: multinational corporations and private equity firms. Multinational corporations are the more traditional partners and can provide invaluable expertise in the field, but there is growing interest in the corporate governance and financial expertise that private equity firms can offer Mexican family-run oilfield service companies. Though some of the largest projects are likely to be self-financed by major corporations, a number of smaller participants are already using private equity firms to back new ventures in Mexico with an extended exit timeline to account for the rapidly evolving regulatory environment.

### Balancing the Risks

While the opportunities in Mexico for international players may be attractive, it's important for potential buyers or investors to enter the market with a clear understanding of the compliance, accounting, tax and legal risks they may face.

### Foreign Corrupt Practices Act (FCPA) and related matters

International players looking to participate in the newly available market would be wise to consider the FCPA and anti-bribery compliance risks that come with doing business in Mexico. From the very beginning of a deal, potential investors or buyers should address FCPA and related matters and adopt compliance policies and procedures tailored to the risks in Mexico.

### Application of generally accepted accounting principles (GAAP)

There are many differences between Mexican GAAP, U.S. GAAP and International Financial Reporting Standards (IFRS). In general, Mexican standards are more open to interpretation than U.S. GAAP and IFRS and Mexican companies within the same industry may apply Mexican GAAP differently.

### Quality of the finance function and financial information

Many Mexican companies may not have financial reporting functions that are sophisticated enough to allow management to obtain accurate financial information on a regular basis. In addition, family owners within private companies may overrule existing policies, procedures and controls.

### Tax matters

Recent tax law changes have been enacted in an effort to reduce administrative burden and compliance costs. In addition, the new Hydrocarbons Revenue Law, which implements and regulates the constitutional energy reform, was passed in August 2014. Before that, no special tax regime existed for companies engaged in the upstream sector, as the state-owned PEMEX was the sole participant.

The overall income tax regime for the upstream sector requires contractors to pay hydrocarbon-related taxes and corporate income tax, as well as other applicable taxes. The payments' structure attempts to maximize the government's take in different projects (deep water, shallow water, unconventional, and onshore) and markets scenarios (through sliding scale royalties). The midstream and downstream sectors do not have a special income tax regime.

In addition to corporate and international tax, transfer pricing and national content regulations matters, potential investors or buyers should consider:

- Common pitfalls of cross border investments, such as tax leakage and limitations on the use of tax losses, in connection with tax structuring / modeling efforts.
- Industry specific tax issues in the upstream, midstream and downstream sectors, such as the tax issues related to a consortium, functional currency and asset depreciation, which are topics that may require specialized knowledge.
- Regulations, including thin-capitalization rules, withholding rules, reporting rules on interests, back-to-back rules, exchange gains and losses and inflationary recognition for tax purposes, which may impair the ability to deduct financing expenses on a project, in connection with potential financing structures.

## Conclusions

New Mexican legislation has paved the way for private investment in the Mexican Oil and Gas industry, creating fresh opportunities for international companies and investors. Foreign expertise, technology and financing capability will likely help Mexico turn around its declining production levels and boost its sluggish economy.

The initial (Round One) auction of 14 shallow- water oil blocks is scheduled to conclude in July 2015, with second and third rounds to follow<sup>9</sup>. The second round auction is expected to grant concessions for 10 unspecified oil blocks. The third round auction is expected to grant concessions for mature oil fields. Future auctions of deep-water concession are expected to occur after the current oil price volatility is settled.

Even though falling oil prices are creating a new challenge for the country, Mexico has one of the lowest production costs in the world, and the legislative energy reform is likely to attract significant investment. The next several years may be critical for those companies and investors in the sector that desire to take advantage of the historic opportunities that may result from these legislative changes.

## Endnotes

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