MEXICO'S ENERGY REFORM

Opportunities for the Energy Industry

BY: ROBERT J. DOWNING

WHY THE CHANGE? In less than six months, Mexico's energy industry will be changed forever. To understand the resulting business opportunities, business needs to know why this happened. Mexico's energy sector is often regarded as one of the most closed systems in the world. Declining oil production since 2004, doubling natural gas imports from the U.S. since 2009, outdated electric infrastructure and formidable manufacturing competition from Asia spurred Mexican officials to reconsider Mexico's 75-year-old restrictions on foreign investment and participation. Prior energy reforms, including in 2008, didn't go far enough to incentivize foreign direct investment. Mexico looked to the U.S.'s shale gas revolution to meet its growing demand for natural gas. President Enrique Peña Nieto acknowledges that to compete, "la apertura" (the opening) is essential.

WHAT'S CHANGED? On December 20, 2013, Mexico published constitutional amendments designed to significantly open up Mexico's energy industry to foreigners. The amendments became effective the next day. The amendments changed the paradigm not only for the oil and gas sector but also the power (electricity) sector. Adhering to an ambitious timetable, on April 30, 2014, President Peña Nieto presented a package of secondary laws that would implement the dramatic changes envisioned in the constitutional amendments. Passage of those secondary laws is expected in June or July of this year. Once passed, government agencies must publish regulations, setting forth the procedures consistent with the new and revised laws. Publication of the regulations is anticipated by year end.

WHY WAIT? Because the laws and regulations have not been finalized, some observers have taken a wait-and-see approach. Other companies have elected not to wait. Instead, they are moving forward now, studying the initiatives, developing alliances and determining where the opportunities lie. While the range of possibilities is broad, there are three categories that present themselves as good prospects for the energy industry.

ESTIMATES VARY BUT AS PART OF THE ENERGY REFORM, A MASSIVE BUILD OUT OF PIPELINES IS ALREADY UNDERWAY

SUPPLY CHAIN As Mexico transforms its energy industry, one of the first opportunities will be across the supply chain of equipment, parts, goods and services. Under the existing regime, suppliers have generally looked to one customer—PEMEX, for oil and gas and another customer, CFE, for electricity. With the E&P sector opening up, PEMEX faces competition. There will be new competitors, new customers. And the sector itself faces tremendous growth, creating numerous opportunities for suppliers. Under "Round Zero," PEMEX requested that it be allowed to keep most of its shallow water plays but in large part conceded that the government can make available to competitors unconventional resources and deep water assets. PEMEX lacks the technology and experience to exploit it's shale gas and oil. That creates opportunities for strategic alliances, joint ventures, and "partnering" in general. There has been little development of shale assets along the border and along the Gulf Coast, the primary areas where these resources are located. How extensive are these resources? Estimates are that Mexico has around 555 tcf of shale gas, the sixth largest resources in the world.

If you want insights into what supply chain needs will be to develop Mexico's unconventional resources, think of what was essential to develop the Bakken, the Eagle Ford and the Marcellus. And it won't be just oil and gas services and equipment. Housing needs, water supplies, technological expertise, know-how and environmental services will be at the forefront. And as noted below, PEMEX isn't going away. With additional foreign investment, PEMEX plans to compete, forming alliances and gaining technology along the way. It is already revamping its procurement department in anticipation of increased competition.

The new legal and regulatory framework impacts the remaining activities of the oil and gas value chain too. These are no longer reserved exclusively to the Mexican State. Participation of private companies is allowed. Such activities include treating and refining oil, processing natural gas, exporting and importing hydrocarbons, LP gas, refined products and petrochemicals, as well as transporting and storage unrelated to LP gas, and the distribution and sale to the public of LP gas.

MEXICO LOOKED TO THE U.S.'S SHALE GAS REVOLUTION TO MEET ITS GROWING DEMAND FOR NATURAL GAS

With all the focus on the oil and gas sector, the dramatic changes in the electricity sector are often overlooked. They shouldn't be, in part, because they are important in their own right and, in part, because they directly impact the natural gas sector. A conscious shift to combined-cycle, gas-fired generation plants present a significant opportunity. Electricity prices are subsidized and expensive for industry.

Part of the reform is to bring in new competition and drive down the prices in the electricity sector to make Mexico's manufacturing industry more competitive. Until now, CFE has dominated electricity generation. Aside from self-supply and cogeneration plants, plus some independent power producers, CFE controls all sectors of the market. That changes with the energy reform. Generation and commercialization ("marketing" of power) is opened up to foreign competition. Direct competition is permitted.

As with oil and gas, suppliers will have new customers and an expanding industry. And as with PEMEX, CFE plans to compete under the new regime. And as with PEMEX, that also creates opportunities for those companies that can join with CFE. Mexico plans to move away from heavy fuel oil as a feedstock. And it's not looking to coal or nuclear. That opens up opportunities in the renewables sector as well, as Mexico has mandated that a significant portion of its generation come from wind, solar, hydro and biofuel sources by 2025.

INFRASTRUCTURE Supply chain opportunities are linked directly to infrastructure needs. Estimates vary but as part of the energy reform, a massive build out of pipelines is already underway. Some predict that at least $34 billion in pipeline infrastructure is needed over the next six years just to avoid cross-border and internal bottlenecks, as Mexico becomes increasingly reliant on natural gas. Many of these infrastructure projects will be open to competitive bidding. The pipeline expansion is dwarfed by the infrastructure requirements to exploit Mexico's deep water and unconventional resources. In the case of shale oil and gas, Mexico is essentially starting from scratch. It will need direct foreign investment to move forward. The same holds true in the electricity sector. Even though the government, through CFE, retains "control" of the transmission and distribution systems, the new laws allow for flexibility and creativity in how to finance, install, maintain and operate the much needed expansion and renovation of the transmission lines and distribution lines serving the country. The regulations will detail how this foreign participation can occur. Nearly 50 percent of Mexico's transmission lines are over 20 years old. Less than 10 percent have been built in the last eight years. Approximately 55 GW's of generation capacity are needed over the next few years. That's more or less equivalent to the total generating capacity of the largest U.S. electric utility.

FINANCING, PRIVATE EQUITY With all these opportunities to supply and build out the energy industry, it makes sense to ask, who's going to pay for all this? Given the sheer size of the planned investment, the third category of opportunity is clearly for the financial sector—commercial and investment banks, private equity concerns and perhaps, individual investors. Project financing for some of the larger infrastructure projects is essential. Of course, some of the E&P projects will be self-funded (by the majors, among others) through the traditional combination of project financing, debt and equity. But in the case of unconventionals, participants may turn to the private equity markets to fund their forays into Mexico. Several Asian funds have expressed an interest in exploring (and supporting) Mexico's energy expansion. U.S. private equity firms are also looking for opportunities. Shale gas participants are looking for strategic investors, that is, Mexican and other companies that bring not only funding but industry and local knowledge to the table. Without financing and funding, Mexico will not be able to realize its grand plan to open up the energy industry. Fortunately, it appears that the finance sector is keenly aware of the opportunities that abound. That should bode well for others that want to gain entry to this historic change in Mexico's energy industry.

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