MEXICAN ENERGY AT A CROSSROADS

THE RECENT ELECTION OF PRESIDENT ANDRÉS MANUEL LÓPEZ OBRADOR, AFFECTIONATELY KNOWN AS AMLO, WILL BRING POPULIST CONSIDERATIONS INTO ALL ASPECTS OF MEXICAN ENERGY SECTOR POLICY-MAKING FOR THE NEXT SIX YEARS. BY DINO BARAJAS, PARTNER, AKIN GUMP STRAUSS HAUER & FELD LLP.

AMLO rose to prominence in Mexican politics over the past 20 years by espousing socialistic and nationalist policies. His focus on the needs of the general population and how globalisation and the opening of Mexico's energy sector to increased foreign investment has failed the working poor has made him a beacon of hope for the masses and a champion of national pride.

His election comes at an interesting time for Mexico given that the administration of President Enrique Peña Nieto instituted historical changes with the increased involvement of the private sector in hydrocarbon exploitation and exploration.

President Peña Nieto's policies also transformed the operations of Petróleos Mexicanos (Pemex), Mexico's national oil company, and Comisión Federal de Electricidad (CFE), its national electricity company.

Under President Peña Nieto's revised energy regulatory regime, Pemex and CFE lost their respective monopolies and were redesigned to either compete head-to-head or joint-venture with private sector industry players in developing, owning and building out Mexico's energy infrastructure.

The critical question for President López Obrador will be whether he focuses on stabilising the value of the Mexican peso and the performance of its stock market, which recently lost 10% of its market value in November alone, or whether he begins to institute populist policies to fulfil campaign promises to the masses that elected him.

Given that the recent trade concerns with the United States took a toll Mexico's production industries, it may be important for President López Obrador to allay private investor concerns in order to preserve Mexico's industrial productivity and jobs.

Over the past five years, Mexico found itself the beneficiary of manufacturing and assembly jobs that had been returning from China to North America. Many of the products produced by Mexican factories, not otherwise consumed domestically, have found consumers in the United States.

The preservation and expansion of Mexico's industrial base may provide the AMLO administration with a powerful tool to deliver the promised prosperity to Mexico's working poor. A strong industrial base may provide the country with the necessary platform to attract high-tech and higher paying jobs for its workforce.

The stabilization of the Mexican economy and the further expansion of manufacturing facilities in less industrialised parts of the country may provide him with additional tools to both deliver on campaign promises and maintain Mexico's continued prosperity.

A key component of the success of Mexico's industrial sector is domestic energy policy. Aside from the costs of raw materials, one of the highest costs of production is the price of electricity. Electricity generation costs have been falling over the last ten years due to decreasing equipment prices and lower natural gas prices.

Another important component is transportation costs, which are driven by gasoline and diesel prices. Despite Mexico's vast natural energy resources in hydrocarbons and solar and wind resources, the country remains challenged in meeting the energy demands of its industries and populace.

The country is in desperate need of deep-water exploration technology in order to take full advantage of its vast hydrocarbon reserves in the Gulf of Mexico.

The Mexican government has publicly acknowledged at numerous industry conferences that Pemex's production capacity of petroleum, gasoline and diesel has fallen sharply in the last few years due to lack of reinvestment in refurbishing ageing equipment and refineries.

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gas pipelines needed to meet the country's growing energy demands.

The Peña Nieto administration had looked to foreign investors and energy development companies to augment the country's coffers in meeting growing infrastructure demands.

Recent changes to the Mexican constitution had allowed for private investment in the oil and gas sector by permitting private companies to participate in the exploration and exploitation of hydrocarbons, an activity previously reserved to Pemex for close to 90 years and a source of national pride.

The country's recent hydrocarbon bids had been enormously successful in attracting oil majors, with much needed proprietary technology and risk capital, into working with the government to increase oil and gas production.

On the electricity front, recent renewable energy bids resulted in record low electricity pricing from private development companies that shocked the global independent power producer industry.

Prior to the election results, Mexico seemed to have moved to the forefront for international investment by energy companies and lenders eager to lend into an ever-expanding energy sector.

The unbridled enthusiasm has become more tempered in recent months, with many potential investors electing to take a "wait and see" attitude and allow the AMLO administration time to announce any new directives for the energy sector. Many industry participants are concerned that the reforms enacted by the Peña Nieto administration will be reversed or undermined by new policies or regulations.

President López Obrador's statements that the recent hydrocarbon bid awards and underlying contractual arrangements will be reviewed by his administration have further exacerbated these concerns.

Even international project finance commercial lenders with a long-standing presence in Mexico have begun to shy away from financing infrastructure projects if they have any significant exposure to government offtake or wholesale energy markets dependent on the current market's design created under the recent energy reforms.

Despite potential uncertainty in Mexico's energy market, a number of industry players who see the long-term opportunities remain resolute and continue to expand their market share as their competition waits on the sidelines for the dust to settle.

Their confidence in the market stems from the knowledge that Mexico's energy needs must be met in some manner and that it would be counterproductive for any administration, despite nationalistic rhetoric, to purposefully hinder the supply of necessary inputs into a thriving industrial sector.

Ultimately, the AMLO administration will likely find workable solutions to permit the continued influx of foreign capital into the energy sector in order to leverage available public funds and redirect those funds to desperately needed public services for those living in poverty in less industrialized parts of the country.

Additionally, promoting the delivery of critical commodities such as electricity, gasoline and diesel by the lowest cost producer will ultimately help the AMLO administration deliver on its political objectives by lowering the cost of living for those most in need.

It will be extremely important to have project finance lenders active during the AMLO administration transition period in order avoid any loss of momentum in the development and expansion of Mexico's energy sector.

Other Latin American countries have fallen prey to temporary market uncertainties that have derailed the development of their infrastructure projects and, in turn, their economies. The government will need to actively reach out to the lending community and clearly delineate its proposed revisions to any existing reforms in order to preserve confidence in its energy sector.

Two public lending institutions that will be critical in maintaining Mexico's current pace of development will be the North American Development Bank (NADBank) and Banco Nacional de Comercio Exterior (Bancomext), both of which have been instrumental in supporting some of Mexico's most important energy projects as anchor lenders.

These financial institutions were leaders in financing "first of their kind" energy projects as reforms were being implemented by the Peña Nieto administration. During this period, the commercial lending market had become apprehensive given that regulations and market parameters were still in a state of flux.

The creativity shown by these lenders and their steadfast commitment to private developers during past periods of uncertainty bridged a shallow lending environment and allowed projects to be built while the reforms transformed the market design of the energy sector.

Some commercial project finance lenders have also utilised the shallow lending environment to establish themselves as the "go-to" lenders for energy projects by spearheading the financing of high-profile projects while other lenders withdrew from the market as the reforms were being implemented. Natixis and Sumitomo Bank have become the lenders of choice for a number of active developers.

These commercial lenders have actively pursued short-term and long-term construction and term loan deals at extremely competitive pricing and have tailored their lending arrangements to the particular needs of the project in question.

Similarly to NADBank and Bancomext, they have moved to the shortlist of lenders with current market experience. Their successful track record in closing financings in record time minimises execution risk for future financings where developers are under time constraints to bring projects to market.

One of most active areas of development in the electricity sector following the recent energy reforms has been solar energy generation. The pricing of solar energy in Mexico has reached an unprecedented low generation cost.

Market leaders such as Canadian Solar and Engie have successfully developed and financed world-class large utility-scale solar generation projects under the current energy regulatory regime.

The AMLO administration would be well served in continuing to promote the development of renewable energy projects given that they would assist Mexico in achieving energy independence by taking advantage of its natural renewable energy resources.

Additionally, the development of renewable energy projects, particularly solar projects with storage capacity, near rural communities will allow the government to accelerate rural electrification, without the need to construct costly transmission lines to less densely populated areas, and promote economic development in areas that have been neglected.

Another important area of success resulting from the energy reforms has been the increase of imported natural gas, gasoline and diesel at a time when domestic production of these commodities had fallen to critical levels.

The timing of the liberalisation of the Mexican hydrocarbon commodity markets averted a domestic energy crisis given that increased supply from US vendors helped to augment sharp declines in Pemex's ability to meet domestic fuel demand.

In the absence of increased fuel imports, Mexico's industrial sector would have been crippled by rising fuel costs and purchasing power of the Mexican peso would be been further deteriorated by an increase in the cost of living.

While promoting increased fuel imports cuts against Mexico's goal of becoming more energy-independent, it does provide the industrial sector and the populace in general with an ample supply of natural gas, gasoline and diesel in the near term and will provide more competitive pricing once Pemex is able to increase production of these commodities.

Any attempt to reverse the effects of the energy reforms on the importation of these commodities may have the unintended result of dramatically rising fuel prices in Mexico and will leave the country with fuel shortages at a time when the country is poised to solidify its position as one of the leading export economies in Latin America.

This next year will be a pivotal moment in Mexico's history and a unique opportunity for companies that believe in the long-term trajectory of the country's energy market to position themselves as market leaders and garner market share.

The key to the success or failure of these market participants will be how well they understand the nuances of the market and whether they surround themselves with advisers well-versed in the history and development of the energy market to-date. ■

REUTERS/Goran Tomasevic - President Andres Manuel Lopez Obrador gestures as he addresses supporters after polls closed in the presidential election, in Mexico City