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OUTLOOK FOR MEXICO'S OIL INDUSTRY -- OPPORTUNITIES AND OBSTACLES

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The Revolution Set the Stage

Since the start of the Mexican revolution in 1910, ownership of the countries' natural resources and land have been at the forefront of political life in Mexico. Two major pillars of the revolution, which were codified in the Constitution of 1917, were land ownership (which was eventually implemented under the ejido system of communal land ownership after Lázaro Cárdenas became president in 1934), and the reservation of oil and gas ownership to the nation.

Article 27 of the Constitution of 1917, in particular, states that all land and water, including the subsoil, is owned by Mexico. While many point to Article 27 as the reason why Mexico cannot have production sharing contracts to induce substantial foreign investment in the oil and gas sector, the language in Article 27 is substantially similar to that in many other constitutions that permit foreign companies to share in oil and gas production. Notwithstanding Article 27, the nationalization of the oil and gas sector and the formation of Pemex under President Cárdenas in 1938 or the introduction of the Petroleum Law in 1940, Mexico used forms of production sharing contracts and concessions with various international oil and gas companies (IOCs) until the late 1950's.

However, in 1958, on the last day of the presidency of Adolfo Ruiz Cortines, an amendment was published to Article 6 of the Pemex law to expressly forbid any oil and gas contracts with IOCs where part of the consideration could be tied to a percentage of production or the actual results of oil and gas exploration activities. This specific change and the subsequent regulations promulgated the following year to implement the law have prevented Pemex and Mexico from using any form of agreement where an international investor could participate in the upside of oil and gas exploration and production activities, such as production sharing agreements or contracts where compensation was tied to the quantity and price of oil produced.

Getting Better but Losing Ground

After eight years of decline, oil production in Mexico is again showing signs of promise. Recently, Pemex announced two deepwater finds in the Gulf of Mexico totaling 325 million barrels. In March, Carlos Morales, the head of exploration and production for Pemex, expressed Pemex's hope that by the end of President Enrique Peña Nieto's term in 2018, Mexico would reach daily oil production of approximately three million barrels, an increase of almost 15 percent.

However, even if Mr. Morales' prediction is fulfilled, this would mean only that Mexico will have succeeded in bringing its production back to 2009 levels. Because of increasing demand and energy consumption, Mexico is an oil exporting country that faces becoming a net oil importer within 10 years, based on current projections. Mexico realizes this dilemma and has been looking to find new ways to exploit its reserves and maintain current production levels in the decades to come.

The Need for Reform

Production from Mexico's shallow offshore fields, including Cantarell, continues to decline, and historically productive onshore fields in the southeast of Mexico are not expected to be a source of growth. Therefore, Mexico is looking to deepwater in the Gulf of Mexico and shale formations in the north (including a portion of the Eagle Ford shale formation that extends into Mexico) for future production growth. Deepwater and unconventional plays require substantial capital investments and/or cutting-edge technology. Given existing budget demands and limited resources for technological development, Pemex is hard pressed to pursue all of its existing prospects, let alone develop new ones. Further, Pemex is a major contributor to the general budget of Mexico and has multiple restrictions on its ability to directly reinvest its earnings in exploration and production (Mexico currently relies on the oil industry for approximately one-third of its revenue).

The 2008 energy reform was a significant step in the right direction, and the early success of the Integrated Services Contracts shows that foreign investment is ready to come to Mexico. However, limiting IOC recovery to a fixed percentage of cost recovery and a fee per barrel does not provide the financial incentives for true exploration activities. Further, under existing regulations, IOCs are not able to book reserves under the existing rules of the U.S. Securities and Exchange Commission (SEC). Thus, the principal parties interested in the current contracts are oil and gas service companies and smaller privately held oil and gas companies, which tend to be less concerned with their total amount of proven reserves.

A consensus seems to be building among industry observers and policymakers, including President Peña Nieto and others within the Institutional Revolutionary Party (PRI), that significant additional reforms are needed if Pemex is to take full advantage of the opportunities afforded by Mexico's hydrocarbon resources. Some industry observers believe that President Peña Nieto will propose specific oil and gas reforms within the next year. To be successful, the reforms will need to loosen some of the restrictions on Pemex, address Article 6 of the Pemex law and head off constitutional challenges that will likely come as a result of Article 27.

Article 27 and Proposed Reforms

As mentioned, Article 27 of Mexico's constitution provides that all natural resources are the property of the state and that private exploitation of natural resources must be done through concessions. As has been seen in the energy boom in the United States and Canada, the involvement of the private sector is an enormous benefit to realize the full potential of deepwater and shale finds. While some believe serious energy reform will not come until the next administration, actions already taken by President Peña Nieto, such as the proposal for a new regulator in the telecom sector and the arrest of Elba Gordillo, head of the teachers' union and former leader of the PRI, suggest that his administration may be up to the task of dealing with the next step in the energy reform process.

While the industry assumes reform is forthcoming, questions remain about what the proposed reforms will look like and, specifically, whether Mexico will allow IOCs to participate in the ownership of hydrocarbons after they are captured at the well head. On the U.S. side, the SEC requires a party to have an "economic interest" in oil and gas produced to be able to book reserves. Companies with concessions, production sharing agreements and even some service contract models, such as those in Iraq, have all been able to book reserves. If Mexico could enact a structure that could provide such rights, then publicly traded companies would likely be significantly more inclined to invest in Mexico.

The "Pact for Mexico," which was signed by the PRI and other major political parties in Mexico in December 2012, pledges to "transform energy . . . by attracting investment, developing technology and forming value chains," but also provides that ". . . in all cases Mexico will retain ownership of all hydrocarbon production." Earlier this year, the PRI voted unanimously to remove from its party platform language that restricted private investment in Mexico's energy sector, but based on statements by PRI officials since then, outright privatization of Pemex appears to be very unlikely (and, in this author's opinion, unnecessary).

Some observers predict that President Peña Nieto will propose a reduction of Pemex's tax burden to free up capital to allow Pemex to further reinvest in exploration and production. While this would certainly be a benefit and would loosen the binds on Pemex's ability to develop national resources, Mexico's policymakers should not stop there. Also, it makes economic sense to diversify risk and expand the pool of available capital. With Pemex as the sole operator, Mexico is taking all of the exploration risk. If IOCs were able to invest alongside or in partnership with Pemex, Mexico could exponentially expand the number, type and complexity of projects being pursued in the aggregate.

Permitting private investment in some form is essential and would be best accomplished by permitting Pemex to enter into joint ventures or production sharing contracts with IOCs to develop hydrocarbons. It appears possible that Mexico could accomplish this goal merely by amending the Pemex law and removing the restrictions put in place by President Cortines. Production sharing contracts were allowed under the constitution before 1958, so they could be allowed again. However, as was seen in the constitutional challenges to the Multiple Service Contracts in 2001, the energy industry will be wary of entering into significant investments while the specter of a constitutional challenge still looms. To send an unequivocal signal to the international market, the government could seek to expressly amend Article 27 of the constitution to permit IOCs to own an "economic interest" in production once extracted, which would nullify any potential constitutional concerns.

Opponents of reform in Mexico argue that absolute ownership of natural resources by the state is essential to ensuring Mexico's national security and prosperity and that, therefore, the constitution must not be changed. This argument, which has carried the day since the oil industry was nationalized in 1938, has wide support in Mexico and continues to be perhaps the single largest obstacle to reform.

Transboundary Hydrocarbons Agreement

Supporters of reform might well point to the Transboundary Hydrocarbons Agreement (TBHA) signed by Mexico and the United States on February 20, 2012, as an instance in which Mexico is protecting its national security and prosperity while agreeing to share ownership of production with IOCs. The TBHA outlines information-sharing mechanisms and exploration and production guidelines with respect to potential oil reserves in the Gulf of Mexico that lie between the two countries' maritime borders, with oil produced from these reserves to be allocated between each party according to percentages specified in a unitization agreement. The most likely parties to such an agreement would be Pemex and an IOC. Significantly, the potential exists under the TBHA framework for an IOC (rather than Pemex) to be producing oil from shared reserves that are owned by the Mexican government. In signing and ratifying the TBHA, Mexico seems to have acknowledged the importance of maximizing returns from these shared reserves and, under certain circumstances, allowing operators other than Pemex to develop deepwater assets and share in production. Mexican policymakers could apply the same principle to other deepwater assets and shale reserves to promote partnerships between Pemex and IOCs in these expensive, technologically demanding projects, thereby gaining from the IOCs' funding, technology and expertise. While the ratification of the TBHA has been caught in the political process in the United States, the TBHA is an example of the new types of structures Mexico must develop successfully if it is to maintain energy security for the nation in decades to come.

Conclusion

Mexico could look to international examples where opening markets have created a more robust state oil company and increased overall development, reserves and investment. For example, reforms in Brazil in the 1990s that opened the market to competition to Petrobras and allowed foreign investment under a concession regime led to major investments and a thriving oil and gas industry. While more recent events have hindered Brazil's industry, there is no doubt that opening the market helped bring billions of dollars of investment and exploration into many new areas. Mexico could look to such reforms as some indication of what it might expect for itself.

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In recent decades, significant declines in reserve replacement, massive need for infrastructure development and new technology, and increased demand for energy have made it clear that reforms are needed in Mexico. Lowering Pemex's tax burden or otherwise expanding Pemex's budget would be a welcome reform. However, it is likely that this would have only an incremental impact on Pemex's ability to maintain production levels, much less increase overall proven reserves. Mexico should go further, amending Pemex law and possibly even the constitution to allow for partnerships between Pemex and IOCs in ways that allow IOCs to share in the benefits of production. IOCs have shown great willingness to invest and assume significant exploration risks; however, the level of risk must be commensurate with the potential rewards. Having a fixed price regime can work where there is little or no exploration risk, such as the Rumaila field in Iraq. However, in unproven deepwater wells or when seeking to delineate and prove up complex unconventional plays for long-term development, further compensation is likely needed to induce investment.

Major reform is possible even in a sector that invokes as much passion in Mexico as the energy sector. The other pillar of the revolution memorialized in the constitution of 1917 was land reform and the inalienable right to private land ownership promised under the ejido system. This inalienable right was eliminated in 1992 under President Salinas de Gortari when Article 27 was rewritten. The process of reforming the oil and gas sector has been more difficult than the changes to the ejido system, but reforms have been pursued. Due to a confluence of events, the time seems ripe for further reform that can make Mexico one of the most attractive environments for responsible foreign investment, whether in partnership with Pemex or as independent concessionaires, to bring a new age of discovery and production to Mexico. If the Tri (the nickname for the Mexican national soccer team) can defeat Brazil for the gold medal, it would certainly seem that the Mexican oil and gas industry can do the same.

ABOUT THE AUTHOR

Steven P. Otillar has been representing clients in the development, finance, acquisition and divestiture of domestic and international energy projects for over 15 years, with a particular emphasis on upstream projects in emerging markets.

Mr. Otillar counsels clients on public tenders and auctions for the right to develop oil and gas and major energy infrastructure projects, including exploration and production blocks, pipelines, and wind, solar and natural gas power projects. He regularly negotiates and structures a variety of investment arrangements – including joint ventures, joint operating agreements, farm-in/farm-out agreements, shareholder agreements, alliance agreements, teaming agreements and joint bidding agreements – relating to the development of major energy and infrastructure projects. Mr. Otillar also handles the underlying tender, construction, engineering and procurement documentation. In addition to representing project sponsors and operators, he has represented financial institutions and other funding sources in financing the acquisition and development of oil and gas properties, drilling rigs, infrastructure and renewable energy projects.

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