LOS ANGELES
Daily Journal
www.dailyjournal.com
THURSDAY, MAY 13, 2014
PERSPECTIVE

Mexico's looming energy gold rush

By Dino Barajas

Last December marked a watershed moment for Mexico's energy sector. The Mexican government announced the long-awaited proposed reforms allowing greater private investment in the energy sector, particularly with respect to hydrocarbons (a.k.a. oil and gas). Historically, given the results of the Mexican revolution and the ousting in the 1930s of private investors involved in Mexico's oil sector, suggested reforms to the status of the government's ownership of hydrocarbon resources were the third rail in Mexican politics. Public sentiment and national pride kept oil and gas reserves firmly within the control of Petróleos Mexicanos (Pemex).

Recently, declining production and the realization that the introduction of deep water drilling technology held by the private sector was gravely needed in order to help Pemex maintain its position within the global stage as one of the world's leading oil producers have forced the Mexican government to reassess its stance regarding the opening of the oil and gas sectors to private investment. Additionally, the power sector, which was already opened to limited private investment in 1992, has also benefited from further liberalization under the current reforms.

On April 30, President Enrique Peña Nieto formally presented to the Mexican Congress the much anticipated proposed secondary legislation needed to implement the reforms which were passed in December. Although the regular session of Mexican Congress had concluded at the end of April, a decision was made to call an extraordinary session during the second half of June to address the legislation.

Given that this legislation only requires a majority affirmative vote to pass, as opposed to the underlying constitutional reforms that required an agreement among the PRI and PAN political parties (Mexico's two largest political parties) to satisfy the supermajority vote of at least two-thirds of the Mexican Congress, PRI leaders (whose party holds the executive branch and a majority in Congress) believe that the reforms will be passed in the extraordinary session and it will not be necessary to carry the debate over to the regular sessions in September. Once majority approval is acquired, the proposed legislation will be returned to the president for final approval.

Associated Press
The Centenario deep-water drilling platform stands off the coast of Veracruz, Mexico, Nov. 22, 2013.

In straddling the delicate balance between attracting private investment dollars into market and avoiding public outcry that the government was abandoning cherished self-determination principles held close to the hearts of Mexicans, the government was shrewd in noting that all hydrocarbons were still the property of the state while the resource laid in the ground but that private investors could nonetheless reflect those same resources on their balance sheets for accounting purposes. This will prove to be an important distinction for both sides and their constituents.

These historic reforms will permit the private sector direct investment (and co-investment alongside Pemex) in the hydrocarbon sector utilizing production sharing and profit sharing arrangements, among other creative structures, to be proposed as the investment program develops.

The primary attraction for the new private sector investors will be in the exploration and exploitation of oil and natural gas resources. International oil companies have been waiting patiently for an opportunity to work with Pemex on deep water drilling opportunities in the Gulf of Mexico and now their day has come. There are a number of known reserves in the Gulf Coast which Pemex has been unable to convert into producing reserves due to lack of necessary technology. These properties will provide for low risk initial investments for private investors and near term high revenue producing properties for the Mexican government and Pemex. This is a true win-win scenario and the makings of a success story which the Mexican government can utilize to attract additional investment dollars for riskier properties in the future as the low hanging fruit is harvested.

Another area of pent up investment demand is the exploration and exploitation of shale gas along the United States-Mexican border, particularly with respect to the Eagle Ford formation along the Texas-Tamaulipas/Coahuila border. Shale gas development comes to an abrupt end at the border given the inability, to date, of private investors to profit from the exploitation of the resource in Mexico. Today, Mexico imports up to 30 percent of its annual national consumption of natural gas from U.S. producers. With the proposed development of its own shale gas resources, Mexico stands to once again become a net exporter of natural gas.

Although the Mexican power sector has already benefited from vast amounts of private investment since the mid-1990s, the renewed interest in the Mexican energy sector as a whole by the international infrastructure development and private equity investment communities will have spillover effects which will bring new participants and increased investment dollars into the sector. Renewable energy development has already been on the uptick during the last five years as the Mexican government has adopted policies which have made renewable energy power generation cheaper and more efficient. Given increased competition and uncertain tax policy in the U.S., wind and solar developers have poured into the Mexican energy market as a means of diversifying their development pipelines and increasing profit margins.

Mexico has had the blessing of being in the "perfect storm," where challenges in other Latin American markets and in the U.S. have forced investors to reconsider their investment strategy for the Americas, while Mexico has had the benefit of sustained domestic growth and an investment grade rating. Uncertainty in other oil and gas producing regions has also repositioned Mexico as a key area for hydrocarbon resource development in order to promote energy security for European countries and the U.S.

The key to Mexico's success in transforming its energy sector will be to make transparent and consistent strides in establishing a comprehensive design for an open market. Investors must believe that the new reforms will have staying power despite changes in the political winds and that there is a level playing field between themselves and Pemex. Domestic considerations must also be managed to ensure that the Mexican public supports these reforms and views the benefits of reintroducing private investment into the oil and gas sector as bettering the standard of living for everyone.

As new energy investors move into uncharted waters, they would do well to study the lessons learned from past investors in the Mexican power sector during the last 20 years. Edmund Burke's statement that "those who don't know history are destined to repeat it" holds true for the new generation of investors looking to make their fortunes in the bonanza which is the newly opened Mexican energy sector.

Dino T. Barajas *is a partner with Akin Gump Strauss Hauer & Feld LLP specializing in project finance and Latin American transactions. Mr. Barajas has worked in the Mexican energy sector for the last 20 years. He is bilingual. Tel: (310) 552-6613; email: dbarajas@akingump.com.*

DINO BARAJAS
Akin Gump