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MASTER LIMITED PARTNERSHIPS SOUTH OF THE BORDER:

A New Financing Scheme to Fuel Mexico's Energy Infrastructure

For several years, many international oil and gas companies (IOCs) have desired to enter the Mexican energy market, global energy markets' last frontier.

Even though Ronda Uno and the upstream sector (exploration and production) has captivated the attention of IOCs and the media, some of the best opportunities lie in the Mexican midstream industry given the continued growth of demand for gas and refined products in Mexico, with rather limited transportation, distribution and storage infrastructure.

Even if the Mexican energy reforms lead to significant increases in domestic production, Mexico will not see the full benefits of expanded exploration until it solves the dilemma of infrastructure constraints.

The US unconventional oil and gas boom was slowed by the inability to get shale oil and gas to market, and the problem will be exponentially more challenging in Mexico. Although transportation demands exist and will continue to grow, the country risks, including the lack of certainty surrounding the new roles of existing regulatory agencies such as the Comision Reguladora de Energia (CRE) together with the newly formed regulatory bodies such as Centro Nacional de Control de Gas Natural (CENEGAS) may limit the amount of direct foreign investment in the early stages of the reform.

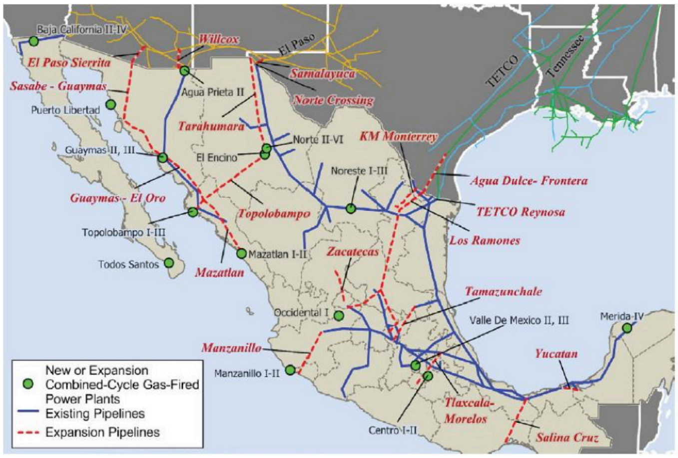
Thus, Mexico has been developing other means to incentivize investment and encourage the development of the midstream sector. One key financing vehicle that has played a vital role in pipeline development in the US is the master limited partnership (MLP). This article will examine the potential for Mexico to utilize MLP model domestically to try an incentivize midstream investment, and investment in the energy sector more broadly as well.

Current Status of Mexico's Midstream Industry

For most of the 20th Century, Petroleos Mexicanos (Pemex) was in charge of building, financing, regulating and operating the national pipeline system.

Due to the constitutional changes enacted in late 2013, Pemex is no longer an energy monopoly, and it is being stripped of its regulatory functions.

PEMEX will now focus primarily on upstream and downstream endeavors while the CRE and CENEGAS have been granted the regulatory authority to administer the National Pipeline System. Currently, Mexico has over 3,000 miles of oil pipelines and 5,500 miles of gas pipelines.

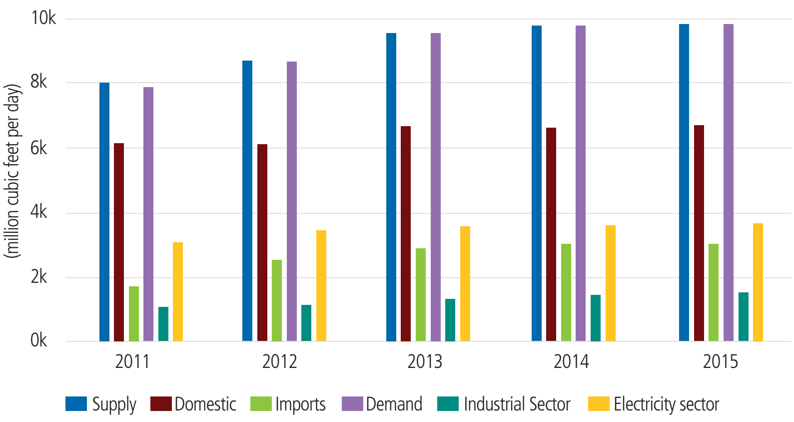


In comparison, the United States (US) has over 57,000 miles of oil pipelines and Texas alone has over 58,000 miles of gas pipelines. In addition to the limited midstream capacity, this map shows that the National Pipeline System does even come close to reaching all of Mexico.

Challenges to Satisfy Domestic Demand and Industry Growth

Mexico has been experiencing one of the fastest growth rates in natural gas consumption over the last 10 years worldwide.

As seen below, increased demand has been driven mainly by the industrial and electricity generation sectors. While demand has been rising, domestic oil and gas production has been lagging at an increasing rate. Several studies have estimated that Mexico will need approximately USD$17 billion [in infrastructure investment] to address the lack of midstream capacity by 2035. This rapid growth in demand, coupled with declining domestic production, was one of the key drivers behind the revolutionary energy reforms in 2014.



Thanks to its energy revolution in the Eagle Ford Shale and the Permian Basin, the US has become a net exporter of natural gas to Mexico in the last decade. This trend particularly expanded with four new cross border pipeline construction projects starting in the last two years and at least three that are currently under negotiations or scheduled to commence construction by 2017.

With ever-rising demand, potential new supplies offshore and in Eastern Mexico, and prospects of inexpensive imports from the US, there is one key question: Now that the Mexican government is not directly involved in the financing, development and operation of midstream infrastructure, where will the money to finance these projects come from? While foreign investment, public debt, and project finance provide possible solutions, there remain vast, relatively untapped financing resources within Mexico itself, and MLPs could be the answer everyone is looking to bring those funds to market.

MLPs 101

MLPs are publicly-traded entities that focus on taking advantage of specific US tax rules to produce stable and predictable cash flows through "Qualified Income". Properly structured MLPs do not pay taxes at a corporate level as revenues are allocated directly to its limited partners.

MLPs first appeared in 1981; in 1987 US Congress limited their use mainly to the energy industry by requiring at least 90% of an MLP's gross income for each taxable year "Qualifying Income". Qualifying Income includes income and gains derived from the exploration, development, mining or production, processing, refining, transportation, or marketing of any mineral or natural resource generated anywhere in the world.

While many MLPs may have internal restrictions on having investments abroad, there is no restriction from a legal perspective. Generally speaking, for purposes of the midstream sector, as long as the MLP is earning income from the transportation or marketing of oil, gas or liquids, that income will be qualifying income.

MLPs are usually two-tier entities: the first tier is a holding company, either a partnership or LLC, which fully owns the Operating Company. Its ownership is split between the "investing public" and the sponsor. The holding company will wholly own a second tier operating company, either a partnership or LLC, which directly or indirectly, holds operating assets that generate Qualifying Income such as pipelines, storage facilities, etc. This corporate structure allows the MLP to access two different financing sources: the public equity markets at the holding company level and the debt markets at the Operating Company level.

While a detailed analysis of the structure and formation of MLPs is beyond the scope of this article, there are essentially [three] fundamental characteristics that each MLP must have:

(i) The MLP must be created as a pass-through entity for tax purposes so it does not pay federal income taxes at the corporate level;

(ii) The MLP's underlying business activity must generate stable and predictable cash flow;

(iii) The units constituting equity ownership of the MLP must be listed and publically traded on a major securities exchange to ensure liquidity and to provide access to the capital markets.

In the past 25 years, over 100 energy-related MLPs have been formed with a collective market capitalization of USD$470 billion. The majority of these MLPs are focused on operating midstream assets that connect oil and natural gas producers to distributors and end users because natural gas transportation services are usually provided under long-term fixed-fee contracts to mitigate potential commodity price volatility. Such long term agreements are also very well suited to generate Qualifying Income for an MLP.

MLPs Role in the US Energy Revolution

Hydrocarbon producers in the US rely heavily on MLPs to finance and develop the necessary midstream infrastructure to connect with consumers. During the last 10 years, MLPs have invested over USD$130 billion in midstream domestic projects and are currently aiming to expand their investments into export facilities to match the increasing domestic supply and the global demand.

Importing the MLP Scheme to Mexico

Currently, Mexico has limited domestic financing sources for midstream infrastructure projects. The closest thing to MLPs in Mexico are the Certificados de Capital de Desarrollo (CKDs).

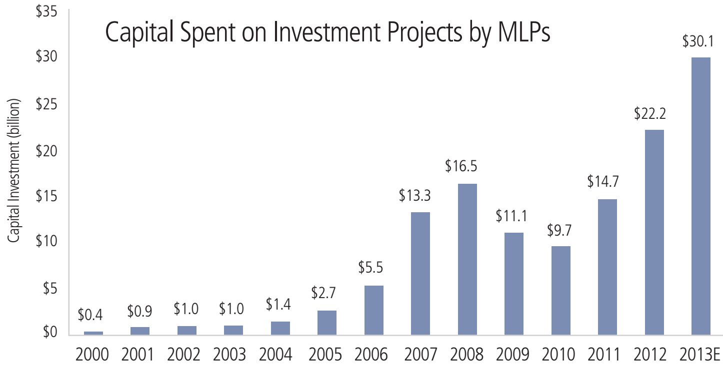
CKDs are securities issued by Trusts to raise capital for infrastructure, real estate, mining, technology and entrepreneurial ventures. Similar to MLPs, CKDs must issue dividends directly linked to the revenue generated by the underlying property or assets held by the Trust.

The CKDs are not debt instruments or bonds; rather, they are cash flow-based securities similar to MLP units, Income Trusts in Canada or the Specialist Fund Market in Great Britain. The CKDs are regulated by the Comision Nacional Bancaria y de Valores (CNBV) and they trade in the Bolsa Mexican de Valores (BMV). Some of the rules imposed on CKDs require fixed-income, predetermined maturity date, more than 20 CKD-holders, and compliance with corporate reporting requirements similar to Sociedades Anonimas Bursatiles ("SABs").

When first created in 2008, the CKDs main goal was to promote market growth through the entry of new securities issuers and the creation of new financing sources for strategic projects. They experienced a short-lived boom in 2010 driven by Mexican pension funds (SIEFOREs) and institutional investors need for low-risk, cash-producing securities. However, the creation of FIBRAS (Mexican real estate investment trusts) together with low yields, market underperformance and legal uncertainty surrounding their underlying projects has significantly weakened investor's interest.

Necessary Changes in Mexican Laws

Even though the CKDs share some traits with the MLPs, they remain very different financing vehicles. CKDs lack the key economic driver behind MLPs, the tax efficiency by avoiding double taxation against income generated from operating company assets. CKDs also do



not offer the flexibility of MLPs in being able to access debt and capital markets for financing needs.

The BMV is currently working with investors, midstream companies and the government to create a scheme that replicates some of the MLP's fundamental elements like creating a tax pass-through entity capable of issuing securitized-participation interests under the Ley General de Sociedades Mercantiles and the Ley del Mercado de Valores to entice retail and institutional investors or creating a "Qualified Income" carve out under the Ley de Impuesto Sobre la Renta to directly promote midstream activities.

Conclusion

Today, Mexico faces an uphill battle to build and modernize oil and gas pipelines that can fuel its internal growth and ignite its global competitiveness. Domestic energy demand continues to outgrow its supply, progressively tipping the net export balance into negative numbers. Additionally, the current midstream infrastructure does not cover the national territory, making significantly more expensive the distribution and marketing of natural gas and oil to areas far from the urban centers, forestalling their economic development.

These are the challenges that the Energy Reform must address by creating a competitive marketplace where midstream companies, whether domestic or international, can gain access to cheap capital with relative ease. However, there are limited investment vehicles within the Mexican legal and financial systems to allow for national and foreign investors to infuse the necessary capital that would ultimately transform such lagging sector. The MLP model provides a successful scheme that could connect institutional and retail investors with midstream companies to jumpstart the Mexican midstream sector. The Mexican government, the BMV and the public in general must push to enact these changes to take full advantage of the Energy Reform momentum and ultimately create a vibrant energy industry.

Eduardo Canales and Steve Otillar from Akin Gump Strauss Hauer & Feld.
Since 1945, Akin Gump has provided a comprehensive suite of services for global energy companies and investors encompassing business transactional, dispute and regulatory matters in key global energy "capitals". Partners in its energy practice were pioneers in the MLP sector 35 years ago and since then have represented MLPs through their full cycles.