Mexico: Expectations and Challenges for the Oil Industry

Mexico’s long-awaited and controversial energy reforms have been one of the country’s most significant constitutional overhauls and are aimed at boosting production and economic growth. The government has high expectations that the opening of the upstream sector to foreign and private investment for the first time in more than 75 years will significantly increase revenues, make state-owned company Petroleos Mexicanos (Pemex) competitive and lead to lower electricity prices. The first contract bidding round took place in July, providing a number of lessons for both the government and potential investors ahead of the next rounds in September and December.

Key Observations

- Although the tenders for the first phase of Round One yielded disappointing results, the government has responded positively to industry demands by improving contract terms, raising expectations that upcoming bidding rounds will attract more applicants
- As Pemex’s productivity continues to decline, and as new players enter the sector, the company will be forced to implement internal restructuring in order to improve its competitiveness
- Low international oil prices, high security risks, social opposition to reforms and high levels of corruption will continue to challenge investor appetite in the Mexican energy sector, pushing the government to offer more attractive conditions

Background

Mexico’s untapped conventional and deepwater energy resources, estimated at up to 87 billion barrels of oil equivalent (BBOE), have long been the subject of international market interest. However, low productivity and a heavy debt burden have prevented state-owned company Pemex from exploiting these resources. Instead, oil production has declined by approximately 32 percent over the past decade, falling from about 3.36 million bpd in 2005 to just 2.27 million bpd in 2015.

Under the key provisions of the 2013 energy reforms, the state maintains ownership of subsoil hydrocarbon resources while allowing companies participating in extractive projects to book reserves in their financial records. Moreover, the reforms have opened up the possibility to sign four types of contracts with private investors, including service, profit-sharing and production-sharing contracts, as well as licenses to allow companies to own extracted resources after paying taxes. The legislation has also strengthened the regulatory role of the National Hydrocarbons Commission (CNH), which is leading the bidding process for investors.

The model for the opening of the Mexican energy sector differs from those applied by the country’s other oil-producing regional neighbours. While energy reforms in Brazil and Colombia focused on opening Petrobras and Ecopetrol, respectively, to private capital, the Mexican government has retained full ownership of Pemex. However, it will also be able to sign contracts with private entities independently from Pemex. Therefore, the quality and profitability of investment contracts depend on the government, rather than on Pemex, which must now compete with private and foreign investors. This is expected to push Pemex towards the implementation of internal reforms and international operational standards in order to be able to compete with its industry contenders. The new legal framework has turned Pemex into a “State Productive Enterprise”, with greater independence from the government and reduced tax liabilities. This framework is expected to lead to the company’s modernisation after decades of acting as a monopoly.

In August 2014, following the approval of secondary legislation for the implementation of the reforms, the Ministry of Energy granted Pemex 83 percent of the country’s probable reserves, but only 21 percent of
Mexico’s prospective reserves in a “Round Zero” bid that was exclusive to the company, making the latter type of reserves an attractive opportunity for investors as they include both shallow and deepwater fields, as well as onshore unconventional fields. This year marks the official opening of the sector to private and foreign investors. As part of the long-awaited Round One, companies and consortia can present bids for exploration and extraction contracts in successive phases.

Earlier in 2015, the Ministry of Energy stated it was confident that the opening of the sector would attract some USD 62.5 billion in investment over the next three years. However, the drop in international oil prices has cast doubt over the government’s optimistic outlook, particularly as the auctioning of expensive unconventional shale oil and gas fields is likely to be delayed as a result. Despite the unfavourable market conditions, the government is still confident that the effects of the reforms will add an extra two percent to Mexico’s GDP growth by 2025.

Round One: Early disappointment but increasing expectations

On 15 July, Phase 1 of Round One opened the bidding process for exploration contracts in 14 shallow water blocks in the Gulf of Mexico with results announced on the same day. Although the government expected to award between four and seven contracts, only two of the 14 blocks were awarded, both of them to a consortium formed by Mexico’s Sierra Oil & Gas, Talos Energy of the US and the UK’s Premier Oil. The results were largely considered a disappointment as only five companies and four consortia presented bids, even though 25 companies pre-qualified as bidders.

Moreover, with the exception of Norway’s Statoil and Italy’s ENI, most of the nine bidders were small or local companies, rather than oil majors.

The unsatisfactory results of this first phase can be attributed to a number of factors. Firstly, the government cited low oil prices as the main reason behind the lack of investor enthusiasm; months before Round One was launched, the CNH had to ease certain conditions to compensate for low market prices. Secondly, companies appear to have opted for a more conservative approach to see how Phase 1 was handled and “learn from the process”, as the CNH described it. However, the most-likely explanation for the low degree of participation is the general dissatisfaction of oil companies with the contract terms that were offered by the Mexican government, which included expensive corporate and security guarantees. It appears that the government had based its position on excessive confidence that the round would be a success regardless of market conditions.

Nevertheless, the government has effectively demonstrated its willingness to make the next phases of the auction more attractive. On 4 August, the CNH announced changes to the terms for Phase 2 of Round One due to take place on 30 September in which it will auction nine shallow water fields in the Gulf of Mexico under five production-sharing contracts. Among other changes, the commission has reduced the corporate guarantee required from bidders in the case of an accident and the USD 2.5 million bid security guarantee now applies to all blocks a bidder wins rather than just one. This reflected some of the proposals that the industry had made before the start of Round One. On 20 August, the CNH released the list of prequalified bidders, which includes big names such as Chevron, Statoil and Shell. The number and quality of bidders in September will determine whether the government’s efforts to respond to investors’ concerns have been sufficient.

Later in the year, during Phase 3 of Round One the government will offer 25 licences for mature onshore
conventional fields in the states of Nuevo Leon, Tamaulipas, Veracruz, Tabasco and Chiapas. So far, at least 68 companies, the majority of which are Mexican, have requested access to the data centre in order to evaluate the fields, which is one of the first steps in applying for prequalification to bid. The CNH will announce the results in mid-December and the government remains optimistic that the contracts awarded during Phase 3 will yield investments of up to USD 620 million. Later on, a fourth and fifth phase will auction deepwater and unconventional reserve fields, respectively, which many companies see as the most attractive and potentially profitable projects. However, the date of these tenders has yet to be defined.

**Challenges ahead**

Despite the government’s confidence that the Phases 2 and 3 of Round One will be significantly more successful, there are a number of challenges that continue to push potential investors to remain highly cautious when evaluating the cost-benefit factor of entering the Mexican energy sector.

**International oil prices to remain low**

The sharp decline in international oil prices since 2014 has negatively impacted investor appetite in Mexico’s energy sector. The government’s expectations of high revenues as a result of the sector reforms are largely based on the facilities provided for deepwater oil extraction via fracking, a highly costly technique which also presents significant geological, environmental and social risks. Most of the auctioned contracts are long-term projects that do not really depend on current oil market conditions as revenue is not expected for at least some 20 years. Nonetheless, the current international context provides little hope that oil prices will return to USD 100 a barrel in the medium term, at least. As a consequence, a number of oil majors have already made significant investment cuts totalling approximately USD 180 billion as of August 2015. BP has reported plans to reduce this year’s investment capital by USD 6 billion and Royal Dutch Shell has announced cuts of USD 15 billion over the next three years, delaying drilling projects in a number of areas, including the Gulf of Mexico.

The current surplus of oil is mainly driven by a market glut and reduced demand. The increase in domestic production by the US has pushed its traditional suppliers to compete for Asian markets at lower prices. At the same time, other producers, such as Iraq, continue to increase production and exports, and Saudi Arabia has also refused to cut production. More recently, the international nuclear agreement with Iran raises the possibility that the country’s potential return to the oil market will further push prices down, adding pressure to the Mexican heavy crude mix. Under this scenario, Mexico will have to ensure that investment conditions remain attractive in order to establish a competitive advantage over other players.

**Security concerns**

Despite Mexico’s market-friendly investment environment, one of the country’s main challenges is the high level of insecurity and the pervasive presence of organised crime. Criminal activity has caused significant losses to the Mexican extractive sector and has raised the operating costs of the oil industry in the past decade. A significant number of both small and large criminal groups finance their operations through the theft and illegal commercialisation of hydrocarbon resources. This trend has increased since 2010, affecting Pemex’s operations despite the federal security protection that the company receives. The theft of hydrocarbons ranges from assaults on lorries transporting crude to extortion schemes targeting petrol station workers, as well as complex bribery schemes linked to Pemex officials and local authorities. The fast expansion of the fuel black market demonstrates the ability of criminal groups to violate any type of security controls both within and outside Pemex.

The number of illegal taps on pipelines is also on the rise, with almost 2,600 illegal perforations between January and July 2015. According to Pemex officials, in 2014 alone, incidents of hydrocarbon theft cost the company more than USD 1.3 billion in stolen product, repairs and clean up. Pemex has also had to heavily invest in security to protect its personnel and assets, a measure that any company entering the sector will need to implement, particularly as the majority of onshore fields due to be awarded in December are located in areas where organised crime is well-established, such as Tamaulipas and Veracruz. Although energy companies are used to working in hostile settings, the high cost of due diligence associated with operating in Mexico can be a disincentive, particularly in the case of deepwater
projects in which the extraction of reserves is not guaranteed.

**Domestic opposition**

Since the expropriation of 1938, which led to Pemex’s creation, Mexico’s oil sector has been a symbol of national pride and resistance against any sort of foreign intervention. Despite the company’s poor performance in recent decades, a number of left-wing parties and activists continue to oppose the opening of the sector, largely condemning the move as the surrender of Mexico’s sovereignty over its resources to foreign entities. Furthermore, President Enrique Peña Nieto’s diminishing popularity ratings amid a series of corruption scandals, poor economic performance and a decline in security has also reduced public trust in many government-led initiatives. In the longer term, there is also a risk that onshore projects, both for conventional and shale oil and gas reserves, will face opposition from local communities over water resources affected by the projects. Since the 2013 approval of the energy reform, a number of protests have taken place and a general sentiment of antipathy is likely to prevail until the promised benefits of the reform are tangible, including low fuel prices. In the meantime, the social climate will remain tense, potentially leading to sporadic but disruptive incidents of civil unrest.

**Corruption**

The high prevalence of corruption at all levels of government in Mexico is a complex issue that results from decades of political privileges that have been strengthened by the ruling class, widespread income disparities, and the generally weak rule of law, among other causes. In 2014, Transparency International’s Corruption Perceptions Index ranked Mexico 103 out of 175 countries assessed and the lack of a reliable anti-corruption body to effectively punish corrupt officials is a major concern for investors. Although the CNH has played a positive role in maintaining transparency at all stages of the bidding process, there remain significant concerns over the implementation of regulatory measures once contracts come into effect, as companies will have to deal with local authorities and other lower-profile public officials.

In particular, even though oil and gas majors have vigorous measures in place to address anti-corruption legislation, such as the Foreign Corrupt Practices Act (FCPA) in the US and the UK Anti Bribery Act, a number of foreign companies and legislators have expressed concern over the risk of inadvertent exposure to corrupt practices in Mexico. Although this is unlikely to deter investor interest at this early stage of the opening of the sector, even the smallest corruption scandal linked to newcomers in the industry would reduce confidence in the government’s commitment to maintain transparency in the process.

**Scenarios:**

- **Best case:** The CNH is able to award all nine shallow water fields and bidders will include a number of oil majors, setting a positive precedent for Phase 3 and further bidding rounds for deepwater and unconventional resources.
- **Worst case:** None or very few companies and consortia, composed mostly of small and local firms, present bids for Phase 2 tenders, further diminishing public confidence in the success of energy reforms and forcing the government to make further changes to investment conditions, even if they result in lower future revenue.
- **Most likely:** Phase 2 and Phase 3 will be slightly more successful than Phase 1, with a higher proportion of contracts being awarded. However, companies (including most oil majors), will remain cautious, seeking to secure even more attractive conditions for deepwater and unconventional contracts, adding pressure to the government to set a date to auction those fields. Moreover, the government will likely seek to offer more attractive investment conditions in order to maintain enthusiasm in the industry despite low oil prices and other social and security risks associated with operating in Mexico.