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Mexico's Oil and Gas Sector Reform

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The energy reform project launched last December in Mexico is groundbreaking because it ends the almost eight decades-long monopoly of the state-owned oil and gas company, Petróleos Mexicanos (Pemex), over the exploration, production, refining, and marketing of oil and gas. The adopted constitutional changes, and above all the possibility to create joint ventures with Pemex, allows private Mexican and foreign companies access to one of the world's largest reserves of both conventional oil and unconventional resources. For Polish companies that specialise in the production of machinery and equipment for oil production, there may be a chance for them to do business in Mexico.

The energy reform measures in Mexico that were passed in December 2013 were hailed both by the government and the private sector as the most important of the past 20 years, and only comparable to the reform of the agriculture sector in 1992. The constitution had vested the ownership of oil and gas with the state and legitimised a state monopoly on activities related to it. The intentions of the changes are to open the Mexican energy industry (under specifically defined conditions) to increased participation from private Mexican and international energy players and encourage the development and expansion of the sector. Mexico's proven oil reserves are currently estimated at 11.4 billion barrels (18th globally). Moreover, in 2012, Pemex (Petróleos Mexicanos), the state-owned monopoly, estimated the country's shale gas potential at 4.2 trillion cubic meters (tcm) and 31.9 billion barrels of shale oil and condensate (its unconventional resources rank it fourth in the world). Along with rights to the exploration and extraction of underground resources, the reform allows competition in refining, petrochemical production, transport, storage and distribution. Hence, the relationship between Pemex and the government has been redefined. Pemex now gains more autonomy but is required to become a profitable corporation, which should lead to a number of changes in the company, for example, to increased productivity.

The changes strengthen government agencies such as the National Hydrocarbon Commission and the Energy Regulatory Commission. A Mexican Petroleum Fund was created to be responsible for receiving, administering and distributing oil and gas revenues. The state remains the sole owner of the resources, but from now on it will be able to enter into contracts with private and foreign companies and specify the distribution of profits and risks in the energy sector. Details about how the hydrocarbon fields will be valued, the bidding process to be used, and the nature of the contracts have yet to be defined. The implementing legislation, due in April 2014, will be a key factor in defining the depth of the reforms and how open the energy sector will be to foreigners.

Political and Economic Rationale. Undoubtedly, these changes are to an important extent a political move by the ruling party. After 12 years in the opposition and having blocked similar energy reforms back in 2010, the Institutional Revolutionary Party (PRI) is back in power and wants to prove that is able to govern more effectively than its predecessor, the National Action Party (PAN). The enthusiasm for reform, however, is much smaller amongst Mexicans. Although 53% of respondents in a survey by research firm Vianovo favoured the reform, only 22% said they believe that it should be a priority of the current government and 56% want Pemex, a symbol of national sovereignty, to remain in the state's hands.

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Besides the strong political connotations, there are solid economic reasons underlying these substantial changes in the country's energy sector. Mexico's hydrocarbon sector has missed out on decades of progress in terms of modernisation and technological advances. Its current management and organisational structure have shown that the country is unable to respond to changes in the industry. A decline in production at the major Cantarell oilfield, the lack of technology to explore for and extract deep sea shale resources, and the lowest GDP growth since the 2009 recession (estimated at just 1.3% in 2013) have strengthened the case for far-reaching reforms in the energy sector. Crude oil production has already been falling for 10 years, from 3.4 million barrels a day in 2004 (its highest point) to 2.5 million in 2013. Although lower costs increased revenues before taxes by 42% between 2008 and 2012, Pemex's fiscal situation meant that it constantly showed negative net profit. This translated into losses to the national budget, as the company typically funded about a third of it. The dependency of public finances on Pemex revenue undermined the company's investments and productivity. According to research conducted by *The Economist* Intelligence Unit in 2011, productivity per Pemex employee was two and a half times less than a counterpart employed in Brazil (Petrobras).

Furthermore, even though Mexico is the world's ninth-largest crude oil producer, it has to import almost 50% of the petrol and 65% of the petrochemical products consumed in the country, mostly from the United States. Due to a lack of funding and, as a consequence, its lesser technical capabilities for the extraction, deepwater resources, which account for 58% of Mexico's estimated oil and shale gas reserves, remain only partially operated. Therefore, the Mexican government estimates that the reforms would boost oil production (to 3 million barrels a day in 2018, and 3.5 million in 2025), foreign direct investment, GDP growth rates (by an additional 2% by 2025), and employment (create more than two million jobs over the next 10 years), and would enhance Mexico's energy independence.

Challenges. Energy reform can be a game-changer for Mexico if two, though difficult-to-balance conditions are met. The first is the need to achieve transparency and create a fully competitive environment for investors. This will depend on the follow-up regulations that will be presented to Mexico's Congress, providing further clarifications on how companies can invest (for example, the types and amount of taxes as well as fees for contracts and government licenses). If, as announced, exploration and mining activities will be allowed only on the basis of contracts that are not commensurate with the risk level, many companies may be discouraged from making the investment. The second condition is that the changes must be accompanied by attempts to reduce corruption (including even within Pemex) and the country's high crime rates. Drug-related violence has discouraged private investment, increased business operating costs (security, kidnap and ransom countermeasures, and even extortion), and diverted government expenditures from other social and economic needs instead of long-term investment projects.

Final Remarks. The reform of Mexico's oil and gas sectors will first of all influence the North American continent because an increase in hydrocarbon production could further strengthen the independence of the continent from supplies from West Africa and the Middle East. Because of its geographical proximity and integrated markets, Canada and, primarily, the U.S. appear to be natural allies in the implementation of Mexico's energy reform efforts. If secondary laws framing the fiscal terms of new contracts seem appealing to investors, though, not only will North American but also Asian and European energy companies look at new opportunities in Mexico's huge and lightly developed fields. Moreover, taking advantage of the reform, local business interests may be willing to invest in hydrocarbon exploration and extraction and will likely seek to form joint ventures with foreign companies.

Poland should pay attention to these developments in Mexico as they may have an impact on the global shale gas industry, as well as the oil sector. Mexico's new National Energy Strategy 2013–2020 recognises that the new targets for shale gas production might require specific regulatory provisions. As a result, Poland and Mexico could establish a fixed platform for the exchange of information on the status of regulations on the exploration and extraction of unconventional gas. Even more important, the goal to modernise Mexico's energy sector could bring with it possibilities for Polish companies that specialise in the production of equipment for oil production. This possibility is confirmed by agreements recently negotiated between Poland and Brazil. Polish companies interested in cooperation with their Mexican counterparts in the energy sector should bear in mind that Mexico has recently been added to the "Polish Prospective Markets 2014" list, a project run by the Polish Ministry of Economy that allows a firm to apply for government support for participation in such things as trade missions, B2B meetings, and trade fairs in Mexico. The opportunity is now for companies poised to take advantage of these programmes and ready to do business in Mexico.