

# New era in Mexico presents significant energy opportunities



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A black and white photograph of an oil pumpjack in a field of tall grass under a blue sky with clouds. The pumpjack is on the left side of the frame, and the grass is in the foreground and middle ground. The sky is in the background.

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## New era in Mexico presents significant opportunities for energy companies

Mexico President Enrique Peña Nieto ushered in a new age when he signed legislation that opened the country's energy industry to private and foreign investment.

The historic bill – a key component of President Peña Nieto's platform to modernize Mexico's economy – provides a wide range of opportunities for foreign oil and gas companies.

The foundation for the new law began in 2012, when the newly elected president began pushing for reform that could inject much-needed capital into Mexican energy production, which represents a substantial component of the country's tax revenue. In 2013, a constitutional amendment was passed, making it possible for Mexico to allow foreign and national private investment in oil and gas for the first time since the industry was nationalized in 1938; the secondary legislation that regulates these constitutional changes was approved and signed in August 2014.

Among industry insiders, there is a great deal of optimism surrounding upstream opportunities in Mexico. Energy companies have been eagerly anticipating the finalization of rules and regulations regarding financial and national content conditions for investment. In recent weeks, the Mexican legislature and Government regulators have begun to shape the specific details.

### Proximity and promise

It's an easy two-hour flight from Houston to the resort towns of the Yucatan Peninsula in Mexico. For years, visitors have flocked to the beaches of Cancún and Mérida to enjoy a few days in the sun.

That same trek may soon be commonplace for US energy company leaders and employees, since Campeche Bay, just to the northwest of the Yucatan, may hold as much as 30 billion barrels of oil.<sup>1</sup>

Further northwest, just two hours from San Antonio, the Eagle Ford shale play extends into Mexico (where it is known as the Burgos basin), in a region where fewer than 25 wells have been drilled.<sup>2</sup> Yet Mexico's shale plays could contain as much as 60 billion barrels of oil – more than the country has produced conventionally since the beginning of its oil and gas industry.<sup>3</sup>

The state oil company, Pemex, says that Mexico's proven reserves total approximately 14 billion barrels of oil and 17 trillion cubic feet of natural gas.<sup>4</sup> But its unexplored potential reserves could be second only to the Arctic region in size and scope.<sup>5</sup>

These estimates – and Mexico's close proximity to the epicenter of the North American energy industry – have certainly captured the attention of US oil companies. The availability of knowledgeable

staff with experience in the Gulf of Mexico, proven equipment and technology and easy access to producing areas make Mexico more attractive than opportunities in other locations.

The Mexican government's original rollout plan had regulators announcing in mid-September which assets would be retained by Pemex – the so-called Round Zero. Round One – when foreign and national investors will have the opportunity to bid on new blocks – was expected to take place in mid-2015.

But in an early August speech, President Peña Nieto said that Round Zero was being moved up a month to ensure that the initial Round One contracts could be announced in the first quarter of next year. Mexico's Energy Ministry (SENER) made its Round Zero announcement on 13 August, granting Pemex the majority of its requested oil and gas producing properties and reserves and providing the national oil firm with about 83% of the country's proven and probable reserves.

SENER also identified 169 production blocks, both onshore and off, that are available for foreign investment in Round One bidding, with total reserves of roughly 18 billion barrels. All of these assets, though, will require significant infrastructure investment. SENER said it will release its initial draft of bid terms for Round One in November, with the tender process beginning shortly after the first of the year.

The accelerated timetable gives companies less time to study the available opportunities, develop a detailed strategy for pursuing Mexican assets and prepare bids. Companies that have not yet developed an internal Mexico team and made key connections within the country may find themselves on the outside when Round One commences.

<sup>1</sup> "What Mexico's Energy Reform Means for Big Oil," *oilprice.com website*, <http://oilprice.com/Energy/Energy-General/What-Mexicos-Energy-Reform-Means-for-Big-Oil.html>, 10 August 2014.

<sup>2</sup> "The fracking divide: Mexico's oil frontier beckons U.S. drillers in wake of new law," *The Washington Post Online*, 19 April 2014, © 1996-2014 The Washington Post.

<sup>3</sup> "Shale gas in Mexico: On shaky ground," *economist.com website*, <http://www.economist.com/news/americas/21601518-mexicos-prospective-shale-boom-will-be-long-time-coming-shaky-ground>, 3 May 2014.

<sup>4</sup> US Energy Information Administration, <http://www.eia.gov/countries/cab.cfm?fips=mx>, 24 April 2014.

<sup>5</sup> "No Turning Back: Mexico's Looming Fracking and Offshore Oil and Gas Bonanza," *desmogblog.com*, <http://www.desmogblog.com/2014/05/12/no-turning-back-mexico-looming-fracking-and-offshore-oil-and-gas-bonanza>, 12 May 2014.

# provision

## Royalties and taxes

The legislation governing the changes to Mexico's energy industry passed with few modifications from President Peña Nieto's original proposal, which was designed to encourage and support foreign investment. Among those changes were provisions requiring small percentage payments to landowners for oil or gas produced on their property, an increase in the amount of oil revenue to be transferred to state and local governments and removal of a regulation that barred profit sharing by oil company employees.<sup>6</sup> None of these should have any impact on the enthusiasm that outside investors and operators have for Mexico's potential.

## Government take

The approved Revenue Law establishes different types of compensation that will be considered the government take and will be paid depending on the type of contract. These payments are independent from the corporate income tax and dividend withholding tax that should be paid by the operators and their shareholders.

The Revenue Law references three different types of contracts that can be entered into with private contractors and state productive entities, such as PEMEX: license agreements, profit sharing and production sharing agreements, and services agreements.

The services agreements will continue to operate in a manner under which the Government will compensate the contractor with a fee paid in cash. For all other agreements, depending on the specific type of contracts, contractors will pay the federal Government either an upfront signing bonus, a contractual quote for exploration period, a revenue-based royalty and/or a profit sharing payment based on the net operating profit or value of hydrocarbons.

## Oil royalties

During the discussions in Congress, the royalty amount for oil production was increased from the recommended amount in the original bill, but royalties for natural gas and condensates were left alone. The new oil royalty rate is based on the value of the barrel of oil. If the price is under US\$48 per barrel, the rate is fixed at 7.5%. If the price per barrel is above US\$48, the rate will be increased according to the following formula:

$$\text{Rate} = [(0.125 \times \text{contractual oil price}) + 1.5] \text{ percent}$$

As a matter of example, if the price per barrel is US\$100, the royalty rate should be 14%. (This rate would have been 10% under the parameters of the original legislation.)

The increase in oil royalties appears to be one of the few negative changes made by Congress to the Revenue Law, as it increases the regressive elements of the compensation formula.

While the royalty increase might not have a significant effect on the license agreements, a significant impact in the economics of the profit and production sharing agreements is expected.

## Natural gas royalties

The royalty rate for associated natural gas is the contractual price divided by 100. The non-associated natural gas royalty formula starts at US\$5 per million BTUs. (When prices are below US\$5 per million BTUs, there is no royalty.)

The formula for determining the royalty when prices are between US\$5 and US\$5.5 is:

$$\text{Rate} = [(\text{contractual natural gas price} - 5) \times 60.5] \text{ percent}$$

If gas prices are above US\$5, the formula for determining the royalty rate for contractual natural gas is the same as for associated gas, i.e., the contractual price divided by 100.

Natural gas produced from shale fields will receive a royalty discount to compensate for the increased cost of production and lower market prices.

<sup>6</sup> "Mexico Passes Fresh Energy Laws, Advancing Sector Reform," *wsj.com website*, <http://online.wsj.com/articles/mexico-passes-fresh-energy-laws-advancing-sector-reform-1407003505>, 2 August 2014.



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Condensate royalties

The legislature approved a progressive rate for condensate, based on price.

Under US\$60, the royalty rate will be fixed at 5%. Over US\$60, the following formula applies:

$$\text{Rate} = [(0.125 \times \text{contractual condensate price}) - 2.5] \text{ percent}$$

Corporate taxes

The corporate tax rate, which will apply to all foreign companies involved in energy production, was set at 30%.

In addition, the tax rules governing Pemex were simplified and the company's future tax burden was reduced. Currently, Pemex is taxed at a rate of approximately 65%, and its payments account for about 35% of Mexico's federal budget.<sup>7</sup> That tax rate will be reduced over the next few years - as revenues from projects developed by foreign participants begin flowing - to enable the company to compete more effectively and increase its investments in training, technology and field development. Further, the Government agreed to take on a portion of Pemex's pension liabilities, subject to certain conditions.

The secondary rules developed by Mexico's Congress also put in place guidelines for national content. Here, too, the Government has applied flexibility, with the most complex types of projects, such as deepwater drilling, requiring no national content and the most basic requiring as much as 25% or more. By 2025, national content should be 35%, but it will be determined by an overall industry average rather than on a project-by-project basis. This approach allows international companies the flexibility to staff projects as needed and allows Mexico time to develop a stronger base of trained workers and oilfield service vendors.

<sup>7</sup> "Industry Insiders: What's Next for Mexico's Reformed Energy Sector," *rigzone.com website*, [https://www.rigzone.com/news/oil\\_gas/a/134454/Industry\\_Insiders\\_Whats\\_Next\\_for\\_Mexicos\\_Reformed\\_Energy\\_Sector](https://www.rigzone.com/news/oil_gas/a/134454/Industry_Insiders_Whats_Next_for_Mexicos_Reformed_Energy_Sector), 8 August 2014.



## Forming successful partnerships

As Mexico's national oil company, Pemex holds the key to the success of this ambitious experiment. Although Pemex will continue to operate independently on a number of vital projects, and some independent projects for foreign participants will be awarded in 2015, many companies entering Mexico are likely to be involved in joint ventures with Pemex. Pemex has announced that it will seek ten "strategic" partnerships to develop 14 of the total fields granted in Round Zero.

The negotiation and execution of these agreements, especially in the early going after the first joint venture bids are announced, will send a strong signal to the industry. If the initial deals that develop are handled with a minimum of complexity and bureaucratic delays, it will be a good sign that Pemex is on board and that the company is willing to work hand-in-hand with companies all over the world.

The strengthening of Pemex' long-term financial position, via the rules adopted by Congress, should go a long way toward making the company amenable to foreign participation. And in fact, Pemex stands to benefit handsomely from these joint ventures, through increased access to capital, technology transfers and the enhanced skills of its technical personnel.

Finally, the regulatory agencies that will carry out further rule making and oversight of the industry will play an important role in the industry's future success. The Finance Ministry (SHCP), the Energy Ministry (SENER), the Comisión Nacional de Hidrocarburos (CNH) and

the Energy Regulation Commission (CRE) are broadly responsible for everything from bidding, contracts and regulation to tax collection. How these agencies work together, how quickly they can scale the learning curve associated with international energy contracts, the approach they take with outside investors and operators and the transparency of their decisions will all have a tremendous impact on the long-term success of Mexico's program.

## Attractive opportunities

In general, Mexican lawmakers took great pains to develop a framework that is attractive to foreign oil and gas companies and investment from private equity firms and others. Mexico also benefited from the learnings gained from other countries' reform movements, and adopted best practices from successful oil-rich countries, such as Norway.

From royalty rates to national content regulations, the Government has put in place flexible rules that will make it possible for foreign participants to manage projects and investments appropriately and make a sufficient return.

And while there are still some unanswered questions, it appears that upstream opportunities hold great promise for Pemex, its international partners and others who participate in the new era of Mexico's energy industry.

## A closer look

For a more detailed look at the financial regulations governing foreign involvement in Mexico's energy sector, refer to EY's 14 August 2014 Global Tax Alert, *New Mexican fiscal system approved for the oil and gas industry*.

## How EY can help

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Our global network of oil and gas professionals collaborates with high performing organizations to assist with strategy through to execution, in order to:

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- ▶ Provide sector-specific supply chain insights with our experienced industry supply chain professionals

Underpinning our performance improvement capabilities are our strengths and skills in day-to-day operations, management and strategic decision-making. These skills are concentrated in the four supporting areas of: people and organizational change, IT advisory, strategic direction and program management.

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- ▶ **Transaction management** – advising on acquisition or disposals, evaluating joint ventures and alliances, buy-side and sell-side due diligence, tax structuring advice and carve-out accounting
- ▶ **Capital management** – evaluating working capital needs, identifying cash flow improvements and debt and equity raising
- ▶ **Integration** – determining and analyzing post-acquisition integration and, in some cases, portfolio realignment

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