Mexico Energy Reforms: Risks and Opportunities

BOARD DISCUSSION

Spotlight on Mexico's Energy Sector

Reforms create new regulatory landscape.

Successful first-round bidders should consider all exploration and production risks.

Soft market for energy insurance will help reduce costs.

Mexico has taken significant steps to reform its energy industry, as the government attempts to capitalize on the country's rich natural resource reserves.

Despite prolonged falling commodity prices, Mexico's energy reforms should have overarching long-term positive consequences, including:

- Attracting foreign investment.
- Fostering innovation and technological advancements.
- Developing local talent.
- Bringing transparency and process.
- Creating energy security.

Mexico Energy Reforms: At a Glance

Enacted in August 2014, the Hydrocarbons Law and Hydrocarbons Revenues Law fundamentally established a new legal framework for all related activities in Mexico. The new laws make it easier for foreign and domestic companies to participate in the country's oil, gas, and power-generation industry.

Regulatory Bodies Harmonized and Reinforced

As a result of these reforms, there has been a demand for greater transparency and rigorous processes. To achieve this, the following regulatory bodies were harmonized and reinforced:

- Ministry of Energy (SENER): Oversees the entire industry.
- Hydrocarbons Commission (CNH): Regulates all upstream activities or exploration and production (E&P).
- Energy Regulatory Commission (CRE): Regulates all midstream and downstream activities, such as pipelines, storage, gathering stations, and refineries.
- Safety and Environmental Agency (ASEA): Ensures safety and environmental protection related to all energy industry activities.

PEMEX Reforms Progressing

Under the new legal regime, the state-owned oil company PEMEX, will not be privatized; however, greater participation and competition in exploration and production will be enabled through regulated contract and tendering processes.

Risk Considerations for Oil and Gas Operators and Investors in Mexico

The opening of Mexico's energy industry has been long awaited. Since the reforms were enacted last year, we have seen significant progress with the first round of exploration and production contracts nearing the end of the tender process.

However, as with all E&P initiatives, there are several risks that must be managed, especially in the context of public-private-partnerships (PPPs) in Mexico's emerging legal and regulatory framework. The table at the right summarizes the risks.

"There are several risk issues that must be managed, especially in the context of Mexico's emerging energy legal and regulatory framework."

RISK ISSUES	
JURISDICTION AND LEGAL SYSTEM	Any contracts awarded will operate under Mexican law, which has several unique attributes. It's critical that operators and investors have legal advisors that are well versed in the local legal system.
REGULATORY REGIME AND CONDITIONS	The regulatory bodies such as the CRE (downstream regulator), CNH (exploration and production), ASEA (safety and security), SENER (overseer), and others have been recently incorporated. They face challenges as they ramp up oversight in a very short period of time, leading to uncertainty, untested definitions, lack of precedence, and a risk of last-minute changes.
HUMAN CAPITAL ISSUES	The shortage of qualified technicians is a concern for companies entering Mexico, as most talent would have to be imported or hired out of PEMEX. This same risk factor applies to the subcontractors and technological partners.
ENVIRONMENTAL RISK	There is extensive work being conducted around regulating environmental liabilities. Currently, companies may inherit environmental liabilities by acquired land or parcel rights, as the regulation places strict liability on the owner.
LOCAL CONTENT	The rules for the first round of license tenders impose a required amount of "local content" that the awardees will have to comply with. This carries its own contractual risk as they will likely need a local joint venture partner or suppliers to achieve the local content quota.
COMPLETION AND DELAY	The blocks of land to be awarded include a provision for certain assets to be invested within two years. Any delay in the start of the work may put the license at risk.
CRISIS AND REPUTATIONAL RISKS	Mexico's geographical and trade proximity to the US augments the risk of reputational damage if something goes wrong. Operators and investors should have a fully prepared and tested crisis response plan in place.
ACTIVITY-SPECIFIC RISKS	There are no special or distinctive risks associated with E&P activities in Mexico; the usual risks are associated with well control, pipe-laying, or shallow water subsea installation.
PROPERTY DAMAGE AND CONSTRUCTION	In some blocks, there are existing assets that represent the potential for third-party damage during the construction phase of the project.
MARINE TRANSIT RISKS	Most of the first blocks of land are in the well-sheltered area of the Bay of Campeche, but still could be subject to hurricane or windstorm exposures.
NATURAL HAZARDS	Mexico and its territorial waters are exposed to earthquake risks, and hurricane tracks are common in the area. Some operators may find that their exposures are being aggregated by insurers as part of the same geographical area that the US Gulf of Mexico lies in, possibly creating capacity constraints.
DECOMMISSIONING	Once the lease for the block expires, all installed assets are transferred to the government, creating a potential exposure if cleanup and decommissioning procedures are required.

Energy Insurance Pricing: A Buyer's Market Helps Investors

Despite the backdrop of prolonged depressed commodity prices, long-term investors and operators in energy and energy-related companies are taking advantage of the current buyer's market by accessing cheap sources of capital from the insurance markets to manage cash flow and reduce liabilities, reducing their overall insurance premium costs, purchasing insurance in areas that were previously omitted due to cost, and renegotiating coverage terms.

Soft insurance pricing for the energy industry is also good news for companies involved in the first round of a tender process. However, they should take an analytical approach in reviewing their risk tolerance and obtaining a clear view on expected losses, expected margins and, ultimately, return on investment (ROI), as they create their financial models for their investments.

Conclusion

The Mexico energy industry reforms are a step forward in a country where foreign and domestic investors have long been calling for change.

The global energy investment community will continue to keenly monitor Mexico's progress toward a robust sector that attracts investment, talent, and economic growth.

As with any emerging market, with opportunities come risks. If these risks are identified and managed appropriately, success can be achieved.

"A soft market combined with an analytical approach will help reduce costs and drive higher returns for investors."

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