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PERSPECTIVE

Mexico's quiet energy revolution

By Dino Barajas

As the world focuses on dramatic shifts in government following the dawn of the Arab Spring, a dramatic revolutionary change may be quietly taking place with our neighbor to the south. Mexico's President Enrique Peña Nieto has introduced proposed reforms to Mexico's constitution which would shatter Petroleos Mexicanos' (Pemex) 75-year monopoly over the exploration and exploitation of the country's vast oil and gas reserves. It would allow the private sector, including foreign companies, to participant alongside Pemex in the exploration of one of Mexico's most important natural resources. Currently, Mexico is one of the top 10 oil-producing nations in the world, and the U.S. is its largest customer for oil exports, accounting for over 80 percent of export sales last year.

Pemex's monopoly over the country's hydrocarbon reserves has roots in the privatization of the oil industry by President Lazaro Cardenas in 1938 in response to the country's post revolutionary desire to gain greater control over its own destiny and the use of its resources by foreign interests. The government's monopoly has become a source of national pride and a recent survey conducted by CIDE, a well respected Mexican educational and research institute, found that 65 percent of those surveyed opposed changes being made to the government's monopoly.

Although similar proposals have been attempted by past administrations, President Peña Nieto's introduction of the proposed reforms comes at a time when Pemex's oil production levels have fallen precipitously over the last few years and the need for deep water drilling technology, controlled by foreign private oil companies, is essential to Pemex's continued success. The introduction of private interests into the country's most protected and insulated industry may be inevitable if the country is to maintain its position as one of the world's top oil producers. Another domestic motivation is to maintain Pemex as Mexico's economic engine for revenue production used to pay for numerous social programs. Oil revenues generated by Pemex account for a large percentage of the country's national budget. Providing Pemex with access to new deep water oil exploration technology will be essential to ensuring that Mexico continues on its course as an economic juggernaut in the region and maintains its investment grade credit rating.

Associated Press

A mural of Mexico's former President Lazaro Cardenas covers a wall alongside the words in Spanish "Pemex is not for sale," Mexico City, Aug. 16.

In a number of other oil-rich regions of the world, oil-producing countries have been able to attract foreign investors with access to cutting edge technology to participate in their markets by offering "partnering" arrangements know as "production sharing agreements," whereby private sector participants joint venture with local state-controlled entities to explore and exploit government controlled oil and gas fields. The private sector entities are then entitled to share in an ownership percentage of the extracted oil and gas commodity as a direct payment for its participation. This provides the private sector participant with the economic upside of the value of the commodity in the open market.

In Mexico's case, the proposed reforms are not intended to provide private participants with a share in the commodity itself, but instead a monetary payment based on the value of the extracted commodity. Assuming that some version of the proposed reforms are approved by the Mexican Congress, the details of how a workable program could be undertaken would still need to be further defined and administered in future regulations. Although private corporate interests would like to see Mexico develop a program more akin to programs available in other jurisdictions, any opportunity to actively participate in the exploration and exploitation of Mexico's vast oil and gas reserves is welcomed.

> The opportunities found in Mexico may create a gold rush effect because of the certainty of success and the huge potential upside for early market entrants.

In comparison with past efforts at reforms in the Mexican energy sector, which included offering the private sector an opportunity to provide goods and services to Pemex through "service contracts" for monetary compensation, the proposed arrangements signaled by President Peña Nieto's proposal would likely garner the greatest level of interest from the large multi-national oil majors because they provide an attractive risk/reward structure which would be competitive with opportunities found elsewhere in the market. In fact, given the certainty of tapping into large known deep water reserves which have laid fallow due to Pemex's inability to secure the necessary drilling technology, the opportunities found in Mexico may create a gold rush effect because of the certainty of success and the huge potential upside for early market entrants.

Given that economic and technical necessities have brought Mexico to these unavoidable crossroads, the near-term development of Mexican energy market will have critical implications in shaping the political and social landscape of Mexico for decades to come. The potential for improving the country's economic outlook through tangible improvements in its oil production capabilities and the government's ability to point to the fact the "ownership" in the actual commodity remains safeguarded within Mexican hands may be sufficient for President Peña Nieto and his administration to overcome public opinion arising from nationalistic sentiments surrounding Pemex's monopoly.

Dino Barajas *is a corporate partner specializing in Latin American transactions at Akin Gump Strauss Hauer & Feld LLP.*