Mexico’s Oil Reform: Managing expectations

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Preview of coming attractions

- The speaker’s three hats
- Quiz about Houston
- History lesson: Who owns the subsurface minerals?
- Visual picture: Mexico’s oil potential and aspirations
- Conundrums
- Star-gazing
- Q&A
A tricome (3 pointed hat)

Charles III of Spain, c. 1786–88
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Fig. 1

**MEI Research Focus: RISK INSIGHT**

*The interface between social science, public policy and business development*

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Mexico Center: Issue Brief

Will Mexico’s Oil Reforms Succeed?

Mexico’s 2013–2014 energy reform promises to bring the country’s economic drivers and regulatory institutions in line with the global practices of free market democracies. If successful, this development would be a 180-degree turn. The accomplishment of such realignment is hardly assured, however, because of endogenous political, institutional, and legal constraints that could openly defeat the aims of energy reform or quietly subvert them, even under the guise of success.

By George Baker, Ph.D., Contributing Expert and Scholar, Mexico Center

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Quiz about Houston

Solve for X

\[ X = \left( \frac{\text{Space}}{Ax} + \frac{\text{Oil}}{Bx} + \frac{\text{Medicine}}{Cx} \right) + \left( \frac{\text{Arts}}{Dx} + \frac{\text{Higher Ed}}{Ex} \right) \]
Answer to Quiz about Houston

• It is the exponential demand by the oil industry for increased signal processing of geoscientific data that drives technological innovation in the oil industry, with direct spill-over effects in space and medicine.

• Indirect benefits are investments in higher education (the Baker Institute, for example) and in the visual and performing arts.

For discussion of this observation about Houston, read my article

« Houston - Carrefour de l'or noir » (Sciences Humaines, Mis à jour le 15/06/2011)
http://www.scienceshumaines.com/houston-carrefour-de-l-or-noir_fr_24612.html
History lesson

A quick survey of five (5) centuries about just one question: *Who owns the subsurface mineral rights?*
Who owns the subsurface minerals?

Isabella I of Castile

Answer: The Crown (1492-1894)
Who owns the subsurface minerals?

Porfirio Díaz of Mexico

The immediate result of the change in law was a major oil boom in Mexico, in the upstream, midstream and downstream. Two prominent oilmen in Mexico were Edward Doheny (US) and Weetman Pearson (UK).
Who owns the subsurface minerals?

Constitution of 1917

Article 27. All natural resources in national territory are property of the nation, and private exploitation may only be carried out through concessions.

Answer: The State (Since 1917)
Who owns the subsurface minerals?

Sir Weetman Pearson of England

In 1889, he founded the first EPC company in Mexico, winning major contracts. In 1909, he founded EL AGUILA (Mexican Eagle) oil company.

But you don’t mean to apply Article 27 retroactively, do you?

“We bought the land, with mineral rights, under the then-current law.”
Who owns the subsurface minerals?
Lázaro Cárdenas of Mexico

Unable to definitively resolve the controversy over the retroactivity of Article 27—and exploiting the pretext of a labor dispute—the oil industry was nationalized.

Oil company assets in Mexico were seized and the companies were expelled.

Answer: The State (Controversy resolved by expropriation in 1938)
Mexico and the Shale Revolution

Eagle Ford formation, Texas

In 2012, only 3 wells of shale oil/gas were drilled in Mexico. By contrast, in the USA that number grew to 9,100.
Mexico’s shale gas potential is large

Estimates of 150-450 Tcf

Enough to supply current U.S. gas demand for 17-50 years
Big expectations from upstream redesign (aka, reform)

During the next years oil production will come mainly from South-eastern Basins, while supply in the middle and long terms is estimated to come from the Deep Gulf of Mexico and unconventional plays.

The implementation of the Energy reform to assign blocks to Mexican and international companies, together with a favorable fiscal regime will promote the supply of shale gas in the near future.

Source: CNH 2014-02-05 Shale Potential in Mexico Portfolios 2013 – Upper Scenario. Includes the development of discovered non-associated deep water fields

CNH February 5, 2014 Shale Gas Potential in Mexico
Pemex 2.0

Deepwater and ultra deepwater drills in the Gulf of Mexico

While there were only 6 wells drilled in deepwaters and ultra deepwaters in Mexico during 2012, in the USA that number was 137.
What’s going on in Mexican Energy?

1958-2013

CONSTITUTION  LAWS & REGS

Goal: Return to the Executive and Legislative Branches the authority to adapt energy policy and law to evolving technologies, business models and market conditions.

Examples: Shale Revolution and Deepwater

2013-2014+

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The right course correction
Conundrums
Possible glitches

Paraphrasing Winston Churchill’s remark about the U.S. Government:

THE MEXICAN GOVERNMENT WILL ALWAYS DO THE RIGHT THING IN ENERGY POLICY—AFTER HAVING EXPLORED ALL OTHER POSSIBILITIES.
Doing the right thing by Pemex

- Create a Pemex 2.0 as a mercantile, stock-issuing company
  - Majority state-owned
  - Unrestricted minority shares in the NYSE
  - Mandate to qualify as an operator outside of Mexico
  - Free managers from status as public servants
  - Introduce global hiring of managers/executives
  - Establish English as the corporate language

- Benefits
  - The business model has been tested in court, lawsuits, arbitration and in public opinion.
  - Introduce dynamic of global competitiveness
  - Instantaneous feedback from minority shareholders
Other than doing the right thing

- Restrict public discussion prior to the promulgation of 28 laws
- Create a new legal figure of “State Enterprise”
  - New laws for Pemex and CFE
    - Mandate to seek joint ventures and farm-outs
- Do not update Mexico’s National Petroleum Narrative
- Create unnecessary risks
  - The business model has not been tested in court, lawsuits, arbitration or in public opinion in Mexico or Houston.
  - Can the “State Enterprise” exercise sovereign immunity?
  - Will it be required to follow NAFTA procurement rules?
  - Will its employees be public servants subject to the LFRSP?
Doing the right thing by investors

- Give priority to the license model without Pemex participation
- Unequivocal right to post reserves volumetrically
- Fiscal terms competitive with those in U.S.
- Benefits
  - Participation in a public tender by an American oil company will have positive ripple effects in other sectors of the Mexican economy
  - Evidence that the government has done the right thing.
Star-gazing
What’s going to happen?

• **Pemex to be grandfathered in “Round Zero”** (by Sept. 17, 2014)
  – All profitable production assets
    • Shallow water
    • Onshore
  – Prospective areas ( undiscovered or undeveloped)
    • Perdido (ultra-deepwater)
    • Shale formations (20%)
  – If permitted, Pemex to seek JVs and farm-outs *immediately*

• **Everyone else**
  – Join with Pemex in a JV or farm-out
  – Wait until 2Q+ 2015 for a “Round One” with contractual options
    • License agreement
    • Production-sharing agreement
    • Profit-sharing agreement
As for everything else, Stay tuned!

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Questions or comments?
For your attention,

*muchas gracias*

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