The new El Dorado: Opportunities in Mexico's energy reform

Reforms will create vast new opportunities for international and domestic companies that want to participate in Mexico's oil and gas and power industries.

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In December 2013, more than 70 years after Mexico nationalized its oil and gas industry and 50 years after nationalizing its power sector, the country's government announced it will open the energy sector to participation and investment by domestic and international companies. This is a tectonic shift that brings tremendous opportunities not only to Mexico and its 120 million citizens but also to the private companies, domestic and international, that can now contribute their capabilities, technology and capital to this growing economy's energy sector. Mexico has vast untapped resources (see the sidebar, "Mexico and its energy sector at a glance"), but its national energy companies—Petróleos Mexicanos (Pemex) and Comisión Federal de Electricidad (CFE)—are struggling to meet the country's growing energy needs, as they operate under a regulatory system that has severely restricted collaboration with private investors and companies.

All of that is poised to change under proposed rules that promise to transform what has been one of the most restrictive markets for private investment into a dynamic sector with vibrant competition and rising production. Such a dramatic shift raises questions and concerns, and as the sector enters unchartered territory, we hear many different views on the potential of the energy reform. Will it benefit only a few, or will it unlock the potential of a country that seems to sit perpetually on the brink of development? Mexico has a long history of adventurers seeking riches, and more than a few have lost their way in search of El Dorado.

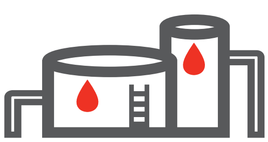
We think the potential is significant not only for Mexico but also for the broader economy across North America and the world (see the sidebar, "Why Mexico's energy reform matters"). Mexico's energy reform is part of a larger set of structural reforms that include the financial, telecommu-

Mexico and its energy sector at a glance

MEXICO

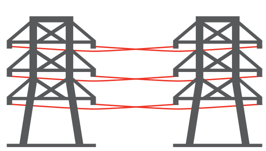
- **120 million** people
- GDP of $1.2 trillion; 3% annual growth from 2000 to 2013
- 13th largest economy in the world
- **10th largest oil** producer globally
- 2nd largest producer of electricity in Latin America
- Estimated 50 billion to 60 billion barrels in reserves in Gulf of Mexico
- 6th largest shale reserves globally, with geology similar to the South Texas basins
- Energy sector could grow to **$500 billion – $675 billion** in revenues over the next five years

PEMEX



- State-owned oil and gas company with a monopoly since 1938
- **$125 billion** in revenues in 2013

CFE



- State-owned electricity company with a monopoly since 1960
- **$24 billion** in revenues in 2012
- Estimated **$120 billion of investments** required in the electrical sector, from 2013 to 2027
- 85% of new investments in generation, transmission and distribution
- By 2020, 47% of investments are expected from the public sector and 43% from the private sector

Source: Literature search

nications and education sectors—an ambitious agenda for change. Mexico's location and membership in the North American Free Trade Agreement (NAFTA) make the success of the reforms critically important for the entire North American economic zone. By the government's own estimates, the reforms could unlock more than 100 billion barrels of oil equivalent (BBOE) of reserves—a resource of a similar scale to the North Sea reserves, whose development transformed that region's economies. Production in Mexico could grow from 2.5 million barrels per day (bpd) to 3.5 million bpd by 2025—and in the process add 2% to Mexico's GDP by 2025.

Debunking the myths

The Mexican Administration and Congress are still defining the rules of reform, but progress appears to be headed in the right direction based on the definitions emerging from the legislative process of the secondary regulation. As always with this type of change, the challenge will be in the way it is implemented by the regulators.

We expect that as the sector opens up, untapped resources, pent-up supply and new technologies will lead to accelerated growth. This is what we have seen in other countries such as Brazil, Colombia and Norway, where opening the energy sector increased activity but also put pressure on the sector and its supply chain. The experience for private capital has been mixed. Energy companies and investors should take a pragmatic approach and hold realistic expectations about the sector's capabilities and ability to deliver against ambitious targets.

Given a history of unmet potential and missed opportunities, many investors are skeptical. But we think some of their concerns reflect a misunderstanding of the evolving competitive landscape and the realities of Mexico. Here are some common misperceptions:

- **Only a few will benefit from the reforms.** We think the benefits will accrue to many more players for at least two reasons. First, the government, as the resource holder, has the power to create competition. Recent license rounds in Brazil and Mozambique confirm a decades-long trend in the energy sector in which more players—international oil companies (IOCs), national oil companies (NOCs), independent oil companies and oilfield service companies—have the financial strength, capability and appetite to participate (see Figure 1). Second, greater transparency in tendering processes and government spending, combined with an increasingly open and challenging media, should reduce the influence of collusion and corruption. We recognize the scale of this challenge, but we believe that if new laws on contract restrictions, local content requirements and bidding processes are implemented effectively, the sector as a whole will gain.

- **Mexican energy companies cannot compete and will be wiped out by foreign competitors.** On the contrary, experience from other countries such as Brazil, Norway and Qatar suggests that deregulation energizes national champions, forcing them to improve their capabilities and performance. Pemex and CFE have real and proprietary technical and operational advantages, such as Pemex's expertise in shallow offshore. Some of these advantages, including local knowledge and relationships, scale and access to information, will be difficult for international competitors to replicate.

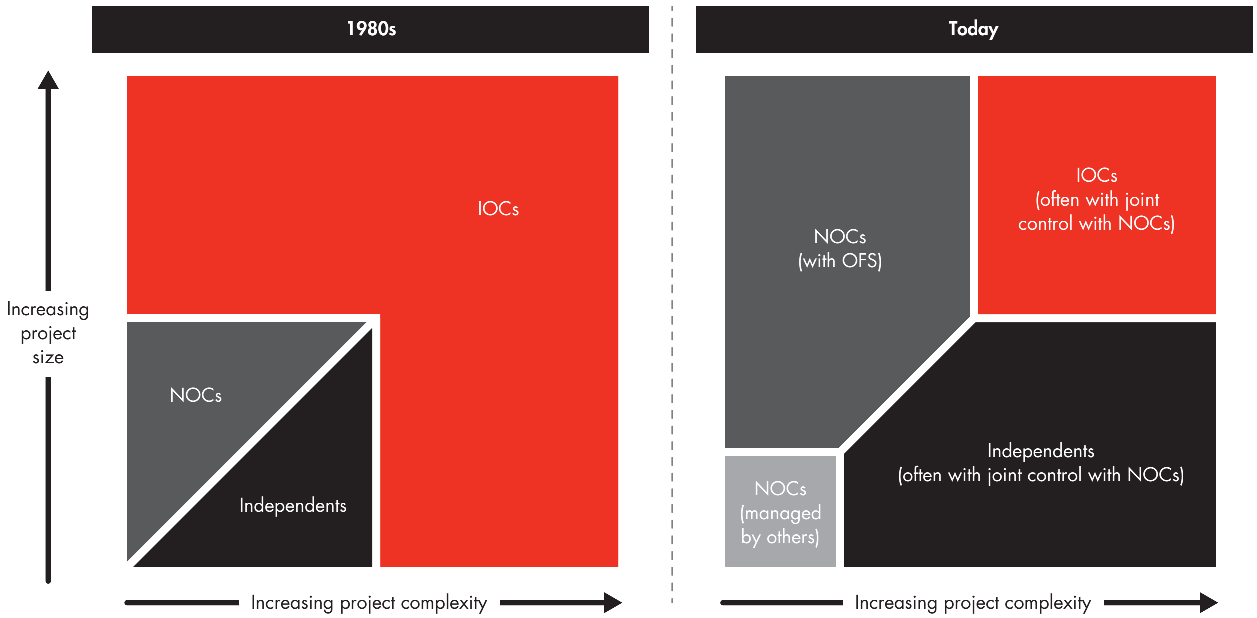
- **It is already too late to get involved.** Mexico's energy reforms will play out over the next 10 to 15 years, and we see ample runway for energy companies and investors to carefully analyze the field and choose their point of entry. Rushing in without properly understanding the rules of the game will not be the right answer for anyone.

Assessing opportunities

Four groups of stakeholders in the energy reforms will be assessing their respective tasks and opportunities.

- The first of these, **the Mexican government,** must now deliver on the promise of reform and "walk the talk" for modernization of the nation. The government

Figure 1: The E&P landscape has shifted as national oil companies, independents and oilfield service companies have taken on larger and more complex projects over the past three decades



Note: IOC is international oil company; NOC is national oil company; OFS is oilfield service company
Source: Bain & Company

must now encourage transparency and competition for the benefit of the economy as a whole—and voters in upcoming elections will undoubtedly judge the government on how well it delivers.

- **Mexico's national champions**, Pemex and CFE, will need to show that they can compete against international players.
- **Mexico's private sector** faces a unique opportunity to participate, bringing to bear its unique capabilities and local experience. Executives should actively evaluate collaboration with international companies.
- Last but clearly not least, the **international energy companies and investors** must include Mexico in their screening and selection of global opportunities, as the scale and diversity presents options for all, from IOCs and NOCs to service companies and investors.

All of these stakeholders will be evaluating opportunities throughout the energy value chain. We highlight three areas that warrant special consideration, but the complete list is long and broad.

Exploration and production. IOCs and a selected group of NOCs are best positioned to bid on Mexico's deepwater projects, as they have the capabilities necessary to compete there. For unconventional resources, IOCs, independents and oil service companies in the US can leverage their experience to develop Mexico's shale fields, which share a similar geology to those in the US. For conventional resources, midsize operators and oilfield service companies can strike partnerships with Pemex to support extracting the full potential from Mexico's maturing assets.

Equipment and services. Serving the future activity levels of Mexico's oil and gas and power sectors will be a great challenge for its supply chain. Supply bottle-

Why Mexico's energy reform matters

- **It is big.** Mexico's oil and gas sector could deploy between $300 billion and $400 billion in capital expenditure through 2020. Although the country's conventional resources are maturing, there are still 50 BBOE to 60 BBOE of untapped deepwater resources in the Gulf of Mexico and 60 BBOE of onshore shale resources.

- **It is relevant.** Mexico's position in NAFTA makes the reform strategically relevant on a global scale. Success will strengthen the North American economic zone, with access to abundant and relatively low-cost energy in a vibrant consumer market and to a large and competitive labor pool.

- **It is a good first step.** Although the reforms are still being shaped by the legislature, the goals and the structure are in line with international practices and incorporate lessons learned from other countries. The goal of 25% local content by 2025, for example, seems realistic.

Our analysis and discussions with executives and regulators in utilities and oil and gas during the development of reform and since its announcement suggest tremendous opportunity, so long as executives understand the investment landscape, identify a differentiated position and set an entry strategy that balances risk and reward. We see opportunities across the energy value chain, from upstream exploration and production through midstream, distribution and refining, as well as infrastructure for electricity generation and transmission.

necks already exist, and a surge in production is certain to exert greater pressure on the industry. Some subsectors are more developed than others, and we expect that as the rules of reform are better defined, these sectors will have higher local-content requirements. Supply bottlenecks are a good leading indicator of where returns are more likely to be captured, as rents migrate to ease those constraints.

Infrastructure. A legacy of underinvestment in infrastructure, not only in the distribution of oil and gas but also in the electrical power grid, has created vast opportunities for investment. As oil and gas production rises, so will the need for pipelines, trucks, roads and rolling stock to move oil and gas from production sites to refineries and retailers. Rising demand for electricity in Mexico, spurred in part by a growing energy sector, will create a need for more power generation and more investment in the transmission and distribution grid.

Mexico's energy reforms represent a watershed moment for the country and its energy sector. As the Mexican government defines the rules, we will all learn more about the specifics and how they shape the opportunities. But we are cautiously optimistic that the internal and external dynamics create a unique opportunity for the Mexican economy.

We encourage executives pursuing this new El Dorado to maintain a close view of the progress in Mexico and to identify opportunities that are aligned with their risk appetites. They should define a roadmap that takes into account the realities of operating in Mexico and defines milestones of success. Should they decide to enter the market, they seem poised to participate in the unlocking of significant new value in Mexico's energy industry for the benefit of its wider economy.

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