Mexico's emerging infrastructure opportunity
With energy reform in Mexico under way, companies are eager to participate in the Mexican oil and gas renaissance. One of the biggest opportunities is the need for investors to develop midstream capacity to support new exploration and production.
Mexico's emerging infrastructure opportunity

The sweeping reform of Mexico's energy industry represents a historic opportunity for oil and gas companies. As the opening of Mexico's energy sector to foreign investment grows closer to reality, many companies are poised to take their first steps into Mexico since its energy industry was nationalized in 1938.

The timing could not be better, as Mexico is an attractive market with significant opportunities for inbound investment. Mexico, the 14th-largest economy in the world, has abundant natural resources, including both conventional and unconventional oil and natural gas reserves. Further, a steadily growing middle class, many of whom work in Mexico's expanding manufacturing sector, is bringing stability and economic growth to many cities. Education is also on an upswing: since 2002, Mexico has doubled the number of two-year colleges and four-year universities available to students. In fact, Mexico now produces more engineers than Germany or Brazil.

Foreign investment in manufacturing — especially in the automobile industry — has created more than 100,000 jobs since 2010. And while overall growth has slowed during the recession, many experts believe that energy reform can play a major role in further developing Mexico's economic clout.

Although the proposed energy-related reforms impact all areas throughout the oil and gas value chain, most US-based energy companies are naturally focused on gaining access to Mexico's energy reserves. The national oil company, Petróleos Mexicanos, or Pemex, says the country's reserves are about 50 billion barrels of oil equivalent, with another 60 billion or so in unconventional resources. Those are substantial numbers that understandably attract a good deal of attention.

Economic indicators suggest that Mexico's decline in oil production is the result of a lack of investment and technology, rather than geology. Consequently, the Mexican Government, under President Enrique Peña Nieto, has placed a significant bet on Mexican energy reform. The Mexican Government is looking for direct investment of approximately US$350 billion in the next five years from outside the country to reinvigorate domestic energy production. The conservative goal is to generate a rise in GDP of approximately 1% per year in the early stages of reform, roughly equivalent to increased economic output of approximately US$12 billion.

Given Mexico's substantial reserves and the interest among international energy companies, including many from the US, those objectives are definitely within reach.

2 Ibid.
Midstream investment is needed now

Generally, the rollout of the energy reforms will likely be more of a marathon than a sprint, with the Mexican Government making certain that basic elements of the new approach are working properly before moving on to more complex activities. It is clear that the Mexican Government is moving ahead thoughtfully to develop new rules and to create the regulatory oversight necessary to manage a significantly different energy industry going forward.

Foreign involvement in Mexico’s exploration and production (E&P) activity is expected to be focused first on deepwater and mature fields that are in need of further investment, as well as new technology to spur production. The opening of unconventional projects, especially onshore shale plays, is likely several years away.

One often overlooked investment opportunity for the oil and gas industry is Mexico’s vastly underdeveloped midstream sector. A recent study by the Binational Center Library at Texas A&M International University suggested that capital investments in Mexico’s midstream segment could total US$17 billion over the next five years.

The issue extends beyond a lack of facilities, as the transportation and storage business in Mexico is fragmented and unsophisticated.

For example, Pemex’s existing transportation network, which connects production centers with domestic refineries and export terminals, includes just over 3,000 miles of pipeline, mostly in southern Mexico, compared to the US total of about 57,000 miles of crude oil pipelines. In addition, Mexico’s crude oil infrastructure is aging, and many parts of the country are unserved.

For natural gas, Mexico has about 5,500 miles of pipelines, while Texas alone has more than 58,000 miles of natural gas pipelines.

The Mexican electric utility, Comisión Federal de Electricidad (CFE), is currently looking to expand natural gas import capacity substantially in the coming years. CFE is expected to seek bids in the near future for the construction of five pipelines in northern Mexico – expected to cost more than US$2 billion – primarily to bring in natural gas from the US to fuel Mexico’s electricity generation and industry.

SENER, Mexico’s national energy ministry, recently projected that US pipeline exports to Mexico will double over the next five years, reaching 3.8 billion cubic feet per day in 2018.

SENER also recently lowered Mexico’s natural gas production forecasts, in large part due to the focus on boosting crude oil production. However, as new liquids production is brought online by foreign investment in E&P, significant investment in transportation and storage facilities will be required in locations that are underserved or currently not served at all.

Without proper investment in the next few years, the transportation challenge that US producers faced in rapidly growing US shale plays may repeat itself in Mexico, with new production stranded from refineries and markets.

In the US, that challenge – at least for liquids production – has been met in part by rail transportation, which may be faster and less expensive than building a pipeline, depending on the location. Similar to the US, however, rail is underdeveloped in Mexico, and rail isn’t an option in some parts of the country. Overall, it is expected that the lack of midstream infrastructure will quickly become an issue for E&P companies working in Mexico.

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11 Ibid.
Structuring midstream investments

In 1997, Mexico opened up a portion of its midstream sector, allowing private investors to build and operate natural gas pipelines (although the Government kept the prohibition on private investment in oil pipelines in place). However, the move did little to encourage new capital flows into Mexico, and the natural gas pipeline industry is still largely controlled by Pemex and CFE. A new agency, called CENAGAS, has now been created to oversee and manage crude oil and natural gas transportation infrastructure.

Mexico’s tax structure is likely to blame, in part, for the lack of investment. Although energy reform in Mexico is designed to be attractive to foreign investors, there is little evidence that the Mexican Government would be amenable to a corporate-tax-free, master limited partnership (MLP) structure. In the US, the recent growth of the MLP structure – in which flow-through entities are listed on the US exchanges – has attracted a great deal of capital to the midstream sector and has enabled domestic companies to expand or build new pipelines, processing plants and storage facilities as needed.

Currently, a number of interests in Mexico are lobbying the government to allow a foreign MLP to form a FIBRA – a type of Mexican REIT – that would own midstream assets in Mexico. The MLP’s unitholders would then pay a withholding tax on distributions, perhaps 10% to 30% (depending on a variety of factors, including, in part, the tax residency of the unitholders), but the entity itself would pay no corporate tax in Mexico, depending on the tax residency of the investor. However, it remains to be seen whether this effort will be successful.
Moving forward

The complexities and tax implications of midstream investments in Mexico should not deter energy companies from pursuing these attractive opportunities. There is considerable upside to be gained from companies that can not only invest capital wisely but can also bring structure and cohesiveness to Mexico's transportation and storage needs – especially on the liquids side of the business.

EY can provide a wide range of planning and advisory services to companies interested in the Mexican midstream market. With the proper structure and approach, companies can participate successfully in this important component of Mexico's energy future.

How EY can help

EY uses its sector-focused approach and global delivery capabilities to help our clients:

- **Tax:** Our oil and gas tax professionals work with leading players to help them make tax a more controllable and predictable cost. We are renowned for our insightful advice and the depth of our industry experience across the globe, where our dedicated oil and gas tax team covers more than 100 territories. We have extensive experience serving major oil and gas companies, large national oil companies and companies of all sizes, including new start-up players that have thrived by utilizing our deep experience. For tax compliance, our professionals can assist companies in the industry with corporate income tax royalty and production taxes, property taxes, statutory reporting, tax accounting, calculations, expatriate tax return processing and indirect tax reporting.

- **Transactions:** Our global network of experienced transaction advisory professionals work with many of the world’s leading oil and gas companies, fast-growing companies and private equity firms on many highly complex cross-border deals in the global market. Our focus is on helping companies improve their growth, profitability and competitiveness, and our global reach means that wherever a company operates in the world, we can help achieve the value that investors expect. We provide a broad range of transaction services for corporate development advisory (valuation and strategic finance), transaction management (advisory, transaction support, transaction tax services and post-deal recommendations) and capital management (corporate restructuring and capital markets).
Our key areas of focus for companies in the oil and gas industry include:

- **Corporate development advisory** – company, portfolio and asset evaluations and review of internal decision support models
- **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

Our global team of supply chain and operations professionals can provide insights into operational and financial improvement opportunities for infrastructure by addressing the critical areas for oil and gas companies, including procurement, logistics, engineering, field operations, manufacturing and distribution. Our practitioners focus on helping clients operate their end-to-end supply chains more effectively and efficiently in order to improve cash flow and profitability.

Our practitioners work collaboratively with our clients to build solutions for:

- **Strategy development**: market dynamics and decision making, scenario planning, multi-modal transportation evaluation, forecasting and demand assessment, cost and operational modeling, and analysis and design of international trade flows
- **Integrated operational planning**: crude planning and trading, analysis and tracking, crude and refinery operations scheduling and optimization, and inventory planning
- **Inbound and outbound logistics**: logistics network design, logistics master plan, multi-modal transportation optimization, logistics information systems assessment, design and selection, loading and off-loading terminal and facilities layout design, cost to serve, KPI benchmarking
- **Procurement**: sourcing and contracting of transportation services
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The oil and gas sector is constantly changing. Increasingly uncertain energy policies, geopolitical complexities, cost management and climate change all present significant challenges. EY's Global Oil & Gas Center supports a global network of more than 9,600 oil and gas professionals with extensive experience in providing assurance, tax, transaction and advisory services across the upstream, midstream, downstream and oilfield service sub-sectors. The Center works to anticipate market trends, execute the mobility of our global resources and articulate points of view on relevant key sector issues. With our deep sector focus, we can help your organization drive down costs and compete more effectively.

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