Mexico midstream
Opportunities for investors who move now
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.
US companies and investors should act now to capture Mexico midstream opportunities

Mexico’s ongoing energy reform passed a critical milestone in July 2015, when the first segment of Round One Exploration & Production bidding was completed.

Though the final results of the auction were mixed – and there are undoubtedly lessons learned that will be applied to future bidding – the process was handled in an open and transparent manner, as promised, and it served as an important step forward. After nearly two years of steady progress, it is clear to most observers that the Mexican Government is committed to carrying out reform in a strategic, thoughtful manner, with an eye toward long-term benefits for the country, its national oil company Petróléos Mexicanos (PEMEX) and foreign investors.

It is also clear that Mexico itself continues to offer tremendous opportunity for international energy companies, including US firms – even in a low-price environment. There is simply too much potential to ignore, especially so close to home for Western Hemisphere players.

So as exploration and production companies look to future auctions, midstream companies and investors are eyeing prospects for storage, pipeline and other transportation infrastructure across Mexico. There is no question that Mexico lacks sufficient energy infrastructure to support increased hydrocarbon production and growing industrial and consumer demand. Only 10% of the oil currently produced by Pemex is transported by pipeline to refineries; the remainder is carried by trucks – mostly by small businesses or individuals – or rail. The same is true of gasoline refined in Mexico and its transportation to retail locations.

Pemex’s existing transportation network, which connects production centers with domestic refineries and export terminals, includes just more than 3,000 miles of pipeline, mostly in southern Mexico, compared with 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.

Mexico is just as underdeveloped in the natural gas transportation segment, with about 5,500 miles of pipelines. By comparison, Texas alone has more than 58,000 miles.
Infrastructure needs will grow

The question, then, isn’t one of need – it is one of timing. When should midstream companies/investors move forward?

The answer is now. Mexico needs more infrastructure today, and those needs will only grow as reform adds additional production of both crude and natural gas and as Mexico’s Federal Electricity Commission (CFE) begins a planned build-out of modern natural-gas-fired power plants.

Already, we are beginning to see movement in Mexico’s midstream sector. There have been a number of announcements in recent months about major pipeline projects planned for Mexico. In March 2015, US-based private equity firms BlackRock and First Reserve announced they had acquired a 45% equity interest in two planned natural gas pipelines – called Los Ramones I and II – that will link natural gas from Texas’ Eagle Ford shale fields to manufacturing facilities in central Mexico. And in April 2015, Pemex and First Reserve announced an additional agreement to invest US$1 billion in midstream infrastructure throughout Mexico.

Enrique Ochoa Reza, Director of Mexico’s CFE, announced in the spring that his agency had hopes of expanding natural gas pipelines throughout Mexico by 75% by the end of 2018 to power electric generation facilities. CFE is planning US$10 billion worth of electricity and natural gas infrastructure projects before the end of the decade, including a 500-mile underwater pipeline to carry South Texas natural gas to the port of Veracruz.

Mexico could also become a larger export market for gasoline produced at US refineries, which are the most efficient in the world (and that currently benefit from supplies of low-priced feedstock). The US currently exports 3,000–10,000 barrels of conventional motor gasoline a month to Mexico, but US refiners are increasingly looking to Latin America as an outlet for their products. If Mexico opens up imports to compete with Pemex refineries, there would be an additional need for gasoline transportation and terminal infrastructure.

With regard to pipeline regulation, there is still a great deal of discussion around the final business model Mexico’s reform will allow. But the bottom line is, as capital flows into the country on the exploration and production side of the business, the need for investments in midstream will only grow.
Get smart...today

Today, there aren't a lot of US-based midstream companies/investors who have much experience dealing in Mexico. But if the country’s infrastructure needs create a “land rush” mentality in the near future, those companies on the ground already will have a distinct advantage. Rather than having to elbow their way to the table, companies with a presence in Mexico – and especially those with a Mexican partner – will find themselves with the best opportunities for success.

That means it's essential to get smart as soon as possible about Mexico's midstream sector and its growing needs. And it means developing a strategy for involvement should be done as soon as possible.

In the US, bidding on midstream assets and opportunities has become extremely competitive, so companies and investors are used to being prepared for tough negotiations. But there are some unique nuances about Mexico's situation that make the environment different than what companies face domestically.

First, there is a definite opportunity to help shape pipeline regulations with the Comisión Reguladora de Energía (CRE), the Mexican equivalent of FERC, along with CFE, which is involved in power generation. In upstream, the National Hydrocarbons Commission (CNH) was very engaged with outside companies, listening to their needs and interests and shaping regulation that was inclusive. Midstream companies that have held back from opening offices in Mexico or engaging with Mexican partners may find themselves locked out of tariff discussions, tax negotiations and other key elements of pipeline regulation.

Those voices are needed to help create a more attractive playing field for outside investors with needed expertise and capital, one that will lead to a more competitive market for energy transportation within Mexico. US companies have a great deal to offer the CRE in terms of actual market experience and knowledge of how rate structures impact competitiveness.

Second, a number of Mexican conglomerates are eager to be a part of energy reform. Some of these companies have business units already engaged in the energy industry in some fashion; others are looking to get involved as partners with foreign companies that can bring expertise and practical know-how. But all of them offer capital, an in-depth knowledge of national and local politics, and strong connections to the Mexican construction and labor industries.

For example, Mexican telecommunications magnate Carlos Slim recently created an energy company called Carso Oil & Gas, which has already partnered with US-based Energy Transfer Partners LP and MasTec Inc. to win a contract for a natural gas pipeline from Waha, Texas, to Mexico's Chihuahua state. The list of potential partners is a long one, including Grupo Mexico, Alfa SAB, Empresas ICA, Alpek SAB and many others. While not all of these conglomerates are likely to get involved, their interest in Mexico's energy future makes them interesting possibilities for joint ventures and other types of partnerships.

Finally, there is a unique opportunity for large international oil companies, which are primarily interested in Mexico's deepwater offshore blocks. Those companies have unequaled expertise in developing complete hydrocarbon value chains, and they have a lot to offer the Mexican Government in terms of integrated packages to pull together deepwater production with related onshore and offshore infrastructure and even refining or petrochemical facilities. Offering up a more inclusive energy package could be the key to winning the rights to drill in deep water.
Timing and strategy are crucial

Midstream companies and investors interested in Mexican opportunities should immediately seek to establish a physical presence in the country, if they haven't already done so. And they should be looking to develop partnerships with respected Mexican companies that can help them navigate the political, business and cultural landscape.

In addition, companies should be working to develop a viable strategy for approaching opportunities in Mexico, based on their unique strengths and logistics with existing projects. That strategy should tie into and support the company's overall view of where global energy markets are headed.

Given the realities on the ground in Mexico and the changing conditions as reform unfolds, it makes sense to approach any strategy in two-year increments. For example, it will likely be 2018 before we see the first lift of new production in Mexico's shallow waters, and the number of wells drilled and flow rates will determine how quickly additional infrastructure will need to be added to handle increased E&P activity. Downstream needs could happen more quickly, depending on the final form regulations take.

Regardless, it seems likely that by 2017, we will see a number of strong alliances and partnerships that are in place and ready to move on new projects. Will your company be part of the action, or watching from the sidelines?
Contacts

If you are ready to move forward, EY can help. We have been actively engaged in Mexico energy reform since the beginning. We have the knowledge, skills and connections to help your company or investment firm identify midstream prospects across all aspects of Mexico's energy industry, develop a unique strategy and pursue partnerships that can help you turn opportunities into reality.

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