Oil Industry

Mexico's Oil Industry Reform—Opportunities for North American Companies

By Guillermo Cruz Rico (Cruz Herrera Ltd.) and Ralph Cuervo-Lorens (Blaney McMurtry LLP)

According to the US Energy Information Administration, Mexico is the second largest supplier of crude oil to the United States, behind Canada. However, Mexico's production has decreased in the last five years from a daily production of 3.4 million barrels in 2004 to 2.6 million in the first quarter of 2009. The decline is understood to have been caused by three main factors: obsolete equipment, depletion of shallow water oil fields, and an inadequate legal framework. In an effort to reverse the situation, the Mexican government has shifted its policy on oil and has brought forth two substantial initiatives: the largest increase in spending in its history, directed at the modernization of ageing infrastructure and equipment, and a new legal framework designed to encourage private participation and limited foreign investment.

Pemex, the state-owned oil company, is considered to be one of the most important and profitable companies of its kind. It currently has six refineries: Minatitlan, Tula, Caderyta, Salina Cruz, Salamanca and Ciudad Madero. President Calderon has announced an 8-year plan which includes the biggest spend in Pemex's history starting with an allocation of US $16.6 billion for fiscal 2009. Current projects include a new refinery in the State of Hidalgo, estimated at US$ 630 million in its first stage with a total spending of US$ 9.1 billion, plus equipment upgrades and major maintenance of the other six refineries. Of note in this regard is the construction of 22 green plants which will produce low-sulphur and clean fuel at the Ing. Antonio Dovali Jaime and Gral. Lázaro Cardenas refineries. The Mexican government's modernization plan also includes oversight services in maintenance at the pipelines in the states of Tabasco, Campeche, Chiapas and Veracruz, and exploration projects in deep-waters in the Gulf of Mexico (such as the US$463.5 million contract awarded to CGG Veritas for three-dimensional seismic mapping of a 75,000-square-kilometre area of the Gulf seabed). Overall, the federal government's plan calls for an average expenditure of US$15.4 billion a year until 2015, with 62% going towards existing oil fields, 20.8% being used in exploration and 16.6% destined for future oil field development.

This ambitious plan presents significant business opportunities for private sector firms, whether domestic or foreign. Pemex is facing an acute shortage of specialized personnel and suppliers to take part in these projects. It is estimated that between 2010 and 2015 more than 406 million man-hours will be required to complete the necessary engineering for the construction of the new refinery in Tula and the reconfiguration of those in Minatitlan and Salina Cruz. Put another way, an average of 3,900 engineers will be needed each and every year until completion of the projects. Projections suggest that the bulk of the work will involve the following areas: 28% electricity installation, 25% pipelines, 25% construction, 15% process and 10% on mechanical aspects. In addition, suppliers will play an important role in providing training and consulting services related to installation, operation and maintenance of the new equipment required for each facility.

The recent reforms in Mexico's oil and gas sector represent a vast business opportunity for foreign oilfield and other service companies.

With respect to the legal framework, the legal reform package passed in November 2008 gave Pemex a more modern corporate structure and removed some of the constraints it previously labored under with respect to procurement: corporate self-governance, new and exclusive rules for hiring, buying and leasing, and a new third party contract structure with cash payments and performance bonuses in the areas of new technology and timely service delivery. In addition, a historic regulation was passed on September 23, 2009. The new set of rules in *Reglamento de la Ley Reglamentaria del Artículo 27 Constitucional en el Ramo Petrolero* (Regulation for the Law Regulating the Article 27 of the Mexican Constitution on Oil Matters) is of fundamental importance to the private sector in this industry: for the first time private parties, whether domestic or foreign, will be allowed as service providers in oil and fuels storage (i.e., gasoline, diesel, etc.), distribution, and in pipeline transportation activities. Private investors will also be able to participate in certain refining activities, an area previously exclusively reserved by law to Pemex. The Regulation is a major breakthrough in the reform of the Mexican oil and gas industry and provides an important opportunity for the

©2009 Thomson Reuters

private sector in an industry that has been closed to any form of private role for over fifty years.

The basic intent of the legal reform, then, is to facilitate the ability of Pemex to meet operation and development requirements through the increased use of private sector service providers. Although this reform does not go as far as allowing for partnerships with the private sector, it does provide the company with the ability to develop its own financing vehicles free of government oversight.

The reform in this sector is not over. With a new Chief Executive Officer, Juan Jose Suarez Coppel, and an imminent second round of legal reforms shortly to be sent to Congress the oil industry in Mexico is set to continue to change the way it does business with the vigorous and increasing participation of the private sector. The next round of reforms is expected to focus more on modernizing the industry. Deep-water exploration and exploitation could well be placed in the hands of a second state-owned company, one with an innovative and specialized corporate structure and legal framework. The litmus test of the next round of reforms will be the manner and extent to which participation of the private sector is made a feature of the new Mexican oil industry. A short while ago this kind of concept would have been regarded as a pipe dream. The recent reforms, together with the crisis of production (and revenue) that Mexico could very well face in the next short years, have made it a likely scenario to contemplate.

With a historic budget and new rules for contracting, buying and leasing, the recent reforms in Mexico's oil and gas sector represent a vast business opportunity for foreign oilfield and other service companies with the technical and financial capacity to undertake the challenging exploration and development work that Mexico requires if it is to maintain its role as one of the world's major oil producers.

Guillermo Cruz Rico, FLC, LL.M. (memo@memocruz.com) is Foreign Legal Consultant for Mexico authorized by the Law Society of Upper Canada, Ontario, and Managing Director at Cruz Herrera Ltd. in Toronto. Ralph Cuervo-Lorens, M.A., LL.M. ACI.Arb. (rcuervolorens@blaney.com) is a Partner at Blaney McMurtry LLP in Toronto.

 ©2009 Thomson Reuters