MEXICO

Going with the flow

Despite some reservations, many fund managers view Mexico's energy reforms as a huge opportunity. Yvonne Li runs the rule over the country's post-monopoly environment

Financial markets cheered Mexico's recent ground-breaking energy reform, calling it a game-changer as it effectively ends the dual monopolies of Petroleos Mexicanos (Pemex) and the Federal Electricity Commission (CFE) and opens up the oil and electricity sectors to private investment.

The passage of the new electricity and hydrocarbon laws fuels the conviction that money will flow into the country's energy sector – which benefits from strong political support, fast economic growth, a highly-skilled workforce and a reliable legal system.

For infrastructure investors, the speed of Mexico's reform surprises many in a positive way. In particular, the 2014-2018 National Infrastructure Plan, which sets aside 3.9 trillion pesos ($299 billion) to be invested in the energy sector, gives them confidence that the government has a genuine intent to make things happen.

Fund managers say they expect to see a lot of deals coming out of the midstream and power generation space on the heels of the reform agenda, which is seen as a necessary step for the world's 14th-largest economy to improve its long-term domestic oil production and to lower energy costs for its companies and people.

DECLINING PRODUCTION

Years of monopoly by Pemex saw the country faced with declining oil and gas production, with analysts estimating that domestic oil output would drop by more than 50 percent from 2010 levels by 2025 under a status quo approach.

This is widely seen as unacceptable, given that oil reserves in Mexico are on par with Saudi Arabia's.

Mexico also has what the US Energy Information Agency (EIA) says are the sixth-largest technically recoverable shale gas reserves. However, it is a net importer of natural gas from the US because of the slow development of its gas resources and growing demand from the electricity sector.

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So the country is in acute need of access to oil and gas resources yet to be tapped. And, due to a lack of local know-how, this will require foreign capital and expertise.

Investors also hope that the reforms will serve as a counter-balance in the face of tougher times ahead, in which global long-term interest rates will increase and capital flows may reverse to developed countries and away from emerging markets such as Mexico.

'POSITIVE STEP'

"I think [the reform process] is a very positive step, and they [Mexico] are on the verge of an oil and gas boom," says Todd Bright, managing director and head of private infrastructure, Americas at Swiss private market specialist Partners Group.

Partners Group recently bought a majority stake in Fermaca, a gas pipeline operator in Mexico, tapping into the growing need for energy infrastructure between Mexico and the US.

Mexico's ambitious goal to double its power generation by 2028 means it needs a nationwide backbone in the form of a natural gas network to import large quantities of cheap natural gas from its northern neighbour.

An inadequate existing natural gas pipeline network and a lack of transmission infrastructure has seen local industry miss out on many of the benefits of the US shale gas boom, which significantly lowered North American natural gas prices, and thus electricity costs, for industrial and residential users.

Mexico's national energy ministry, SENER, projects that US pipeline exports to Mexico will reach 3.8 billion cubic feet per day (Bcf/d) in 2018. This would be more than double the US exports to Mexico in 2013, which averaged only 1.8 Bcf/d.

The announced energy reforms are expected to culminate in the CFE and Pemex tendering over 20 projects in the next 12 to 24 months.

Plus, for the first time in history, the CFE, which generates much of its electricity using natural gas, has been identified as just another market participant in generation and transmission.

This means the utilities and private sector will play by the same rules – competing openly to generate and sell electricity to the national grid.

"There have been some promising regulatory developments involving energy reform in Mexico, but the penny – or peso in this case – has not yet dropped for most institutional investors in terms of understanding their positive impact on the private investment opportunity that now exists," says Brian Chase, real assets specialist at Campbell Lutyens & Co, an advisory firm and placement agent headquartered in London.

In April, the CFE said it planned to seek private sector bids for five natural gas pipelines in northern Mexico that are estimated to cost $2.25 billion to build.

Three of the five projects that the CFE has announced for this year will connect to Fermaca's Tarahumara pipeline, Partners Group said in the infrastructure section of its semi-annual market outlook report, the *Private Markets Navigator.*

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"For Fermaca alone, we see an opportunity over the next few years that is in the order of half a billion dollars of new investment, if they are successful in their business plan," says Bright.

Looking ahead, Bright said Partners will look at power generation, particularly gas-fired power plants, for investment opportunities in Mexico, calling it "a logical extension" of the work Partners Group does with Fermaca.

For coal – or gas-fired power plants, a certain level of midstream gas expertise is required. "We do feel we have that through our Fermaca position," Bright says.

In spite of complexities, President Peña Nieto's energy reforms are expected to improve the country's long-term oil production, say analysts at the US Energy Information Administration (EIA).

The EIA predicts that Mexico's production could stabilise at 2.9 million barrels per day through 2020 and then rise to 3.7 million barrels per day by 2040, 75 percent higher than in its outlook last year.

A big driver for foreign investment in midstream infrastructure is the award of exploration and production contracts by the Mexican government.

"If there's no exploration and production to speak of... you are unlikely to see the private sector building more pipelines," says Jose Valera, a partner at law firm Mayer Brown, adding that a much simpler permitting process will be used for the midstream space.

RENEWABLE

Most of Mexico's power generation comes from coal-fired power plants, although this is being gradually replaced by natural gas.

In fact, the Peña Nieto administration's energy reform also lays out a plan to generate 35 percent of its electricity from renewable sources by 2024. That is a big jump compared with a contribution of 14 percent from hydroelectric and non-hydro renewables last year.

Infrastructure fund managers say such an ambitious goal gives them a variety of opportunities to capitalise on, especially those that do not have a midstream position in Mexico.

George Osorio, managing partner at Conduit Capital Partners, calls the opportunity following the energy reform "immense," and says his firm is considering setting up a Mexico-only fund. Conduit invests in the independent electric power industry in Latin America and the Caribbean, and its Mexico exposure is mainly in hydroelectricity.

Of the Latin American-focused infrastructure funds tracked by *Infrastructure Investor*, four are Mexico-only funds and their target investments are primarily in renewables.

For example, the Macquarie Mexican Infrastructure Fund, along with Mitsubishi Corp. & PGGM, owns a wind farm called Mareña Renovables in Mexico. The Macquarie Mexican fund has $450 million under management and is two-thirds committed, according to its chief executive officer Jonathan Walbridge.

Fund managers say renewables infrastructure offers a wider and more level playing field compared with coal – or gas-fired facilities where the CFE controls over three-quarters of the country's installed generating capacity, most of which is fossil-fuel power plants.

Typically, the target internal rate of return (IRR) for renewables assets is 15 percent to 20 percent, much higher than for core infrastructure assets such as toll roads, and thus it appeals to foreign investors on the hunt for high returns.

Nonetheless, Partners Group's Bright says his firm will look more cautiously at renewable assets in Mexico. And he's not alone, given that electricity prices may be facing downward pressure with Mexico on the verge of an oil and gas boom.

As Mexico transitions from expensive oil to natural gas as the marginal power generation fuel, wholesale power prices should decline materially in the future compared with current levels. That may create some risk for renewable-sourced power plants, particularly those that don't have long-term power purchase agreements (PPAs), investors say.

Even for those that do have long-term PPAs, such deals struck today could end up out of money for the off-takers at some point in the future, increasing credit risk for the power generators, they say.

However, the growth rate of renewables-sourced power generation has been high in recent years, and that trend is likely to continue in the coming years. Further, the Mexican government is likely to pursue policies that will support the continued development of solar and wind resources, which should translate into continuing opportunities for infrastructure funds.

Mexico's ambitions in the development of renewable energy resources will also translate into rising demand for high-voltage transmission networks, fund managers say.

This is because renewable projects are usually located in remote areas away from major power demand centres in urban areas, and therefore new transmission is needed for both renewable integration and improved system reliability.

FINANCING

Foreign investors used to be frustrated by the lack of a local financing community, with big banks such as JP Morgan Chase or Citigroup unwilling to commit to long-term financing in Mexico. The few sources they could turn to were the multilateral funding sources such as the International Finance Corporation.

Now, the Peña Nieto administration's reform is set to change the financing landscape because new players will be attracted to the country and more investment and commercial banks will start operating in Mexico, sources confidently predict.

Importantly, the participation of Mexico's gigantic pension funds, which are now able to make investments outside of traditional fixed-income products, gives foreign investors a great level of comfort because of the political cover pension funds can provide, which is highly prized in emerging markets such as Mexico.

"The combination of the energy reform and that [the pension funds' participation] means you are going to have very powerful partners. For example, if I'm going to invest in a major pipeline in Mexico, I want to partner with the pension funds because they are going to protect their investments… (and) the government doesn't want to frustrate the pension funds," says Conduit Capital's Osorio.

DEVIL IN THE DETAILS

Nonetheless, there is a lingering issue for fund managers eyeing the Mexican market – the devil in the details. The devil, to some, is getting proof of the transparency of the two monopolies, the CFE and Pemex.

"The challenge is to make sure that it [the reformed market] is as transparent as they say it is going to be… how much of an effect the CFE and Pemex have on energy reform is going to be important. Getting clarity on that ultimately will be one of the major hurdles or opportunities you will see in the next year or two," one fund manager says.

Macquarie's Walbridge rebuffs the concerns: "I think the government is very aware of all the challenges going from the previous model to a new market model and we've seen with some of the laws to date how the government sought to structure some of the early private sector participation."

"It's certainly not any sort of deterrent for us in terms of looking at some of these sectors. We're very actively looking at opportunities across a range of those sub-sectors," Walbridge adds. His enthusiasm may just prove infectious. ■

INFRASTRUCTURE FUNDS RAISED BY VALUE ($bn): 2008 TO H1 2014

Year	All Infra Funds Closed	Latin America	Mexico
2008	$40.27	$1.04	$0.00
2009	$11.08	$1.22	$0.00
2010	$41.37	$1.48	$0.39
2011	$29.23	$0.61	$0.09
2012	$32.24	$1.45	$0.42
2013	$48.51	$1.43	$0.00
H1 2014	$13.64	$0.00	$0.00
Total	**$216.34**	**$7.23**	**$0.89**

INFRASTRUCTURE FUNDS RAISED BY NUMBER: 2008 TO H1 2014

Year	All Infra Funds Closed	Latin America	Mexico
2008	53	7	0
2009	34	7	0
2010	68	11	2
2011	72	13	1
2012	65	10	1
2013	63	2	0
H1 2014	20	0	0
Total	**375**	**50**	**4**

Source: Infrastructure Investor Research & Analytics