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Upstream Oil and Gas Outlook in Mexico and Practical Guidance for Market Participants Beyond COVID-19

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Abstract: This article discusses what is on the horizon for oil and gas companies in Mexico beyond COVID-19. Low hydrocarbon prices, along with the pandemic effects and the regulatory changes in the Mexican energy sector, may lead to a consolidation of market participants, triggering cross-border M&A activity. While planning for this type of transaction, potential sellers and purchasers should consider—in view of intermittent lockdowns and regulatory changes—new risks related to securing antitrust clearance and negotiating material adverse effect provisions.

COVID-19, Oil Price War and Mexico's Energy Policy

As a result of COVID-19 and the drastic reduction in commodity demand coupled with the ramp-up of Saudi Arabian and Russian production, upstream producers in the United States have laid down rigs and shut-in wells and significantly decreased production. Further complicating the already tenuous situation is the lack of liquid storage capacity. The May 2020 short-term energy outlook assumed that the Henry Hub spot price will remain low compared with historical levels in the near term as reduced business activity and higher-than-average liquid storage levels contribute to keeping prices low.[1]

Natural gas prices in Mexico are highly correlated to natural gas prices in the United States due to Mexico's heavy reliance on gas imports by pipeline from Texas (at least 53 percent in 2019),[2] with transactions typically priced off of US benchmarks, such as Henry Hub, plus the cost of transportation. Although natural gas prices may remain low, the former president of the National Hydrocarbons Commission (CNH)[3] considers that at US$3.40/MMBtu, there would be sufficient incentives for Mexican upstream producers to continue with their development plans and for Petróleos Mexicanos (Pemex), together with the CNH, to approve new farmout opportunities in the Burgos, Tampico-Misantla and Sabinas-Burro Picachos Basins. Although farmouts are not the first choice for the current administration, there may not be many other feasible alternatives given Pemex's current balance sheet.

With respect to oil production and given that Pemex failed to meet its investment and production commitments for the first quarter of 2020 (even before it agreed on a 100,000-barrel reduction with OPEC), the reduction in demand resulting from COVID-19 indicates that Pemex's plans may be out of reach for the near future. A way to push toward achieving the production goals would be to enter into new services agreements or alliances with other E&P producers. However, those agreements would not be entered for offshore facilities as, during the first week of June, Pemex announced the suspension of services for different offshore service providers. If new agreements are awarded by Pemex, they may be only for onshore resources. Given the stressed balance sheet of Pemex and the anti-corruption crusade embraced by the current administration and consistent with the form of the agreements awarded during 2019, third-party service providers may expect contractual clauses with strengthened anti-corruption provisions and new financing methods.

Regulatory uncertainty is the main threat for investments in Mexico. During the last couple of months, the Environmental and Energy Security Agency (ASEA) has issued new regulations increasing environmental obligations for E&P producers. The CNH has remained a neutral player in this arena, but the Federal Electricity Commission (CFE) has been a contentious participant in the energy sector. For instance, during 2019, CFE filed requests for arbitration with the purpose of declaring null and void clauses in seven gas pipeline contracts awarded to TC Energy, Carso, Fermaca and IEnova. The arbitration proceeding ended up in a renegotiation of the contracts. During 2020, CFE, amid controversy, has issued and promoted different resolutions severely affecting renewable power plants and grandfathered power projects. The uncertainty generated by CFE should not be underestimated as CFE is a key consumer of natural gas, controls a large share of the natural gas pipelines and is currently tendering processes for the development of additional power plants that would increase its natural gas demands by up to 600Mf3/d.[4]

The silver lining in this regulatory entanglement has been the performance of CNH and the fact that E&P contracts have not been challenged by the federal administration. Despite the anti-corruption revision conducted during 2018, the E&P contractors have been able to continue with their operations without any major obstacle. Furthermore, the CNH maintains an open approach to receiving comments from industry participants, especially when it comes to improving regulations, including those critical for financing, i.e., changes in operatorship and granting of guarantees.

Regulatory Filings and "Deal" Considerations

It is expected that this crisis may trigger an increase of M&A activity within the Mexican upstream sector. Investors interested in acquiring upstream assets in Mexico should consider certain measures to address potential contingencies. As in "normal" times, if government approvals are required, any transaction should include covenants specifying the level of efforts that the parties must utilize vis-à-vis obtaining those approvals. These provisions should be tailored carefully in light of any relevant antitrust risks.

One concern relates to the timing of regulatory filings. In light of the COVID-19 crisis, many regulators either have closed their offices entirely for extended periods of time or have suspended their statutory filing deadlines. Thus, it may be appropriate to revise any deadlines to require that filings (or any subsequent submissions) be filed, notified, etc. within a certain number of days, counting only those days on which the relevant government authority's office is open and accepting filings or notifications (i.e., the definition of "Business Days").

Timing issues also come into play with respect to closing timelines. Because of the COVID-19 crisis, one or more government regulators have suspended review periods. Moreover, some jurisdictions, including the European Union, have strongly suggested that parties involved in complicated transactions (particularly those most likely to be cross-border) withhold notifying mergers entirely until the crisis has subsided. If parties are unable to receive merger control clearance, they may not be able to close their transactions. Be aware of the current timeline to clearance or approval in the relevant jurisdictions and before any relevant regulatory body, and build enough flexibility to account for any potential delays to the closing deadline.

For transactions involving upstream Mexican assets, the other relevant approval/notification is the one to be issued by the CNH, which may be substantially easier to obtain if the parties involved in the transaction participated in the hydrocarbons bidding rounds. Finally, given the current potential changes in energy policy, negotiating a MAC (Material Adverse Change) clause can be quite complicated, and any such clause should be clearly defined to avoid any of the parties' exit for a reason other than those clearly defined within the concept of the relevant MAC clause.

During the next months, the oil and gas sector, globally, will continue to face two challenges: navigating the impacts of COVID-19 that most industries are grappling with and simultaneously managing depressed commodity prices coupled with lower demand.

Participants in the Mexican oil and gas industry will also need to navigate the regulatory complexities created by the current administration, the uncertainty of potential energy policy changes and the Pemex financial crisis. As parties look beyond the COVID-19 pandemic, strategic measures to improve planning and mitigate risk developed during the pandemic can ultimately result, from a commercial perspective, as a positive consequence of this time, with parties augmenting their deal planning around country risk, regulatory regimes, certainty, timing and valuation.

Endnotes

1 *See:* https://www.eia.gov/outlooks/steo/report/natgas.php

2 *See:* https://www.gob.mx/cms/uploads/attachment/file/516275/Prontuario_diciembre_2019.pdf

3 *See:* https://www.naturalgasintel.com/articles/122138-qa-with-juan-carlos-zepeda-on-mexicos-natural-gas-market-development

4 *See:* https://app.bnamericas.com/article/section/all/content/xkjxzpdf7-delayed-plants-speculation-on-tenders-complicate-cfe-bid-to-lift-output