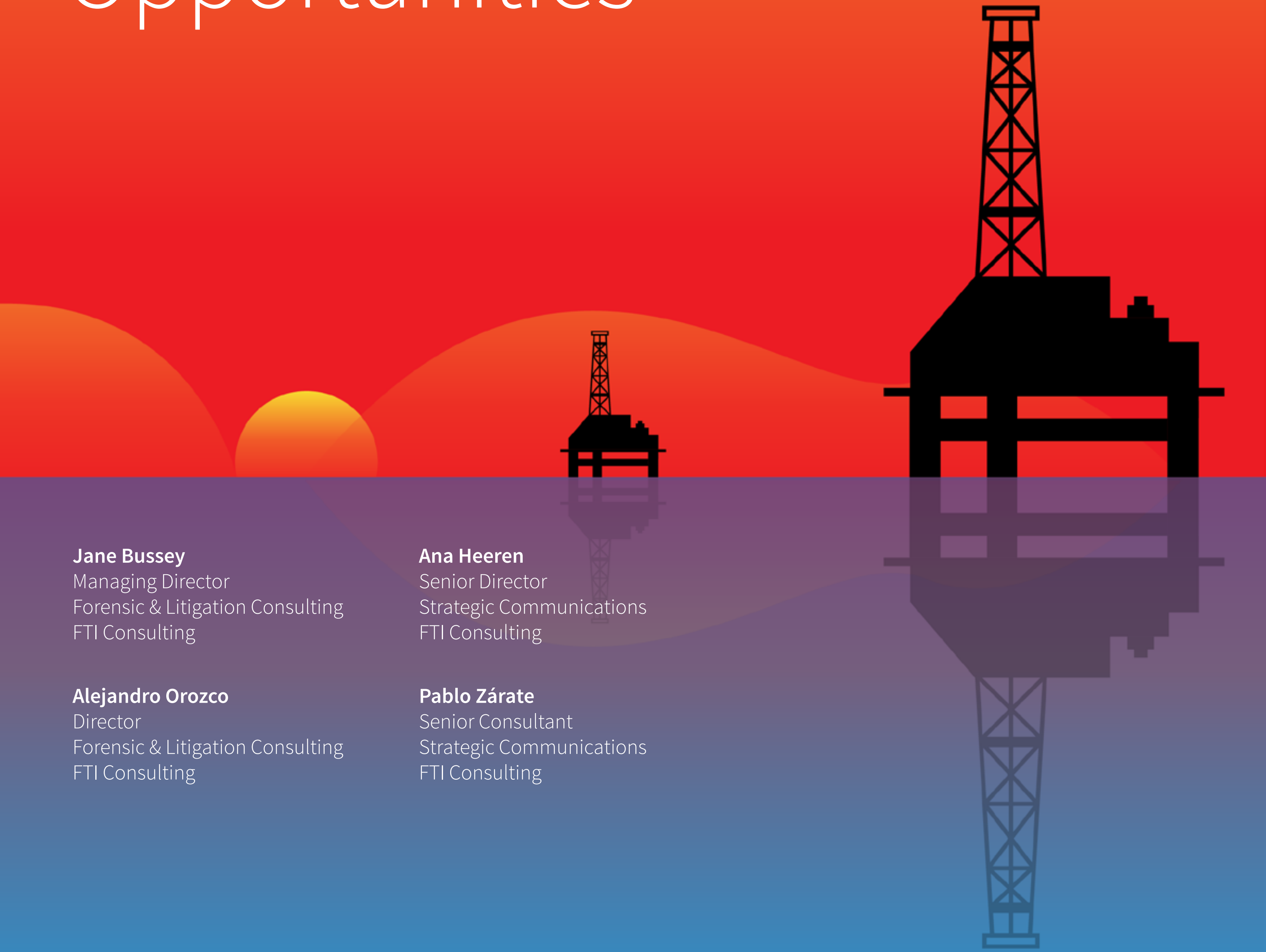
FTI JOURNAL

January 2015

Mexico's Energy Reform: How to Meet the Risks and Seize the Opportunities



Jane Bussey
Managing Director
Forensic & Litigation Consulting
FTI Consulting

Ana Heeren
Senior Director
Strategic Communications
FTI Consulting

Alejandro Orozco
Director
Forensic & Litigation Consulting
FTI Consulting

Pablo Zárate
Senior Consultant
Strategic Communications
FTI Consulting

FTI™ CONSULTING

The Mexican opportunity comes into sharper focus.

Mexico's energy reform, passed in 2013, has generated unprecedented global economic interest. Oil and gas companies, the oil services industry, energy consultants, investors, venture capitalists, trade associations and even local governments (Monterrey, for example, is attempting to brand itself as the "Mexican Houston") right now are jockeying for position as opportunities come into sharper focus and the contracting terms for the first round of bidding are being finalized.

The global energy industry has anticipated reform for decades, and not even Mexico's headline-making problems — corruption, political unrest and extreme drug cartel violence — have shaken the confidence of interested parties. Analysts and experts have pointed out that the first stage of Mexico's energy reform process has gone well. And the speed and transparency with which the government has handled the opening stage's multifaceted challenges have sent positive signals to investors. The opportunities in Mexico's oil and gas sector, the signals say, are not a mirage.

While the contracting terms are not yet set in stone, the government has committed itself to design terms according to international best practices. It has met deadlines for issuing bidding rules for what is known as Round One (see "The Bidding Process Timeline," page 3). Round One follows Round Zero, which was held in August 2014 and awarded 83 percent of the country's proven and probable reserves and 21 percent of its prospective hydrocarbon resources to Petróleos Mexicanos (Pemex), the state-owned energy company.

There, of course, still is the possibility that the current interest will wane. For example, the flexibility granted to the Ministry of Finance to set the contracts' fiscal terms likely will be used as a way to balance the industry's demand for competitiveness with the government's need to maximize oil revenues. Companies may shy away from making commitments from which they cannot back down until the terms for each project can be evaluated.

But with the Round One opportunity — 3.782 billion barrels of oil equivalent (BOE) in proven and probable reserves and another 14.606 billion BOE in prospective resources — and four bidding rounds during the following four years, companies will start considering not whether the potential benefits are worth the risk but how firms will manage the above-ground risks to ensure enduring success in Mexican endeavors.

Four Types of Risk

As companies evaluate their entry into Mexico's energy market, they confront four significant challenges:

- **The regulatory and legal environment**
- **Risks presented by political opposition to energy reform and public opinion**
- **Lack of local infrastructure and talent**
- **Security challenges presented by corruption and drug cartels**

Addressing the first two challenges calls for a comprehensive approach to public affairs; the logistical and security challenges require a strategy to safeguard a company's assets and its reputation.

Challenge 1: The regulatory and legal environment

Final rules for implementing Mexico's energy reforms were released in October 2014, but government agencies and the federal courts lack experience dealing with both the new legal framework and a competitive energy sector. Mexico's energy reforms have created a number of agencies and reshaped existing ones.

Investors wanting a voice during the process of implementing the country's energy reforms will need to know with whom to engage, how to make their case to Mexican authorities and with whom to partner to achieve the best results. As initial actions by government agencies shape upcoming policy decisions, reaching key audiences with tailored messages will be critical.

For example, ASEA (the National Safety, Energy and Environmental Agency) and CNH (the National Hydrocarbons Commission) are building the regulatory landscape of the new Mexican oil and gas sector. Knowing how to send the right message through the appropriate channel to these agencies can be crucial to ensure that the regulations don't set standards that make operations in the sector a logistical and bureaucratic nightmare.

It's also important to monitor the on-the-record activities of key public officials in all related agencies in order to gauge the progress of the reforms and to detect any policy changes. Such signals can provide context for companies to pursue a thoughtful engagement campaign with key stakeholders.

Failing to engage closely with government regulators can create miscommunications and lead to missed opportunities.

Challenge 2: Risks presented by political opposition to energy reform and public opinion

Engaging with stakeholders outside the government may be even more essential than working within it. Companies entering the Mexican market should expect to confront opposition in the public arena as they will become, in a very direct way, the face of the reform. Some examples of opposition that already are visible include the following:

Local environmental and social groups opposed to fracking extraction methods are emerging and gaining traction with the help of international activists. Civil society groups, which can surface spontaneously to pressure government officials, also could emerge.

Land use issues could come to the forefront in a culture where communal land on the outskirts of a community traditionally goes to public uses — and local activists could gain broad support by protesting against foreign companies as opposed to the Mexican government or Pemex.

The left-of-center political opposition continues to express strong sentiment against Mexico's energy reform even after the Supreme Court ruled that the reform will not be subject to a constitutional referendum during the 2015 elections.

Protests may be organized against the very visible construction of new infrastructure and operations such as the installation of onshore wells controlled by foreign companies and the ramping up of hydraulic fracturing.

Changes to Mexico's political system also could have an effect. Term limits will be lifted in 2015, which means incumbents will be campaigning to keep their congressional seats and should be expected to be more responsive to their constituents. Constituent dissatisfaction, amplified through mass communications and social media, has the potential to create controversy, if not unseat reform proponents.

The prospect of any combination of these developments makes it crucial for players in the energy industry to develop a proactive strategy that drives positive news coverage and quickly rebuts factual errors in the press. As part of this effort, building a powerful public coalition will allow companies to speak out without being singled out. A strong public coalition should continually work to set the record straight by educating the public and by fact checking the opposition. Such a coalition would identify allies, support them and mobilize the community to advance an entity's objectives (see "Rapid Response," page 4).

Timing is essential

It's vital to implement a strategic communications program as early as possible. This allows the program to lay the foundation and set the terms for future debates in advance of the opposition's efforts to do the same. It also allows time for necessary research on the issues and the gathering of relevant scientific studies (if appropriate). Across industries and countries, organizations that have failed to define themselves first will be defined by opponents — even when the government is on their side. A solid reputation is built over time but can be lost overnight.

Engage important stakeholders

No education and advocacy-focused campaign can be successful without a genuine and continuous effort to educate those people who have the most to gain from resolving an issue, legislation or crisis. It is important to identify opportunities to bring together interested parties from across the spectrum to create a "surround sound" effect in disseminating educational messages in a timely manner.

In the Mexican context, a successful coalition should emphasize the positive economic and community-building impact that expanded oil and gas development will bring to the country. Social responsibility programs, on top of the jobs issue, also can be part of a program for private companies to give local communities a stake in the private sector's success.

Challenge 3: Lack of local infrastructure and talent

In the northern states of Tamaulipas, Nuevo León and Coahuila, where shale opportunities are located,

The Bidding Process Timeline

2014	2015				
DEC	JAN	FEB	MAR	APR	MAY
Shallow water (exploration blocks)	Shallow water (production blocks)	Heavy oil	Unconventional resources and Chicontepec	Onshore	Deepwater

the infrastructure needs extensive development. Project decision makers will have to consider water management, road construction and housing for workers, along with medical and educational facilities. Energy infrastructure, especially pipelines, currently is limited, although new investment is expected in the near future. And due to the relative scarcity of specialized human resources, companies will have to fight for local talent or look for it abroad. In the next four years, Mexico's energy sector is expected to need about 135,000 additional technical and management specialists.

To address rapidly rising demand for added employees, energy companies will have to establish a careful vetting process to ensure the reputation of potential local partners, service providers and employees. Vetting is one of the best ways to avoid problems, particularly in light of the U.S. Foreign Corrupt Practices Act and Mexico's 2012 Federal Law Against Corruption in Public Procurement. A background check for employees and due diligence investigations for potential partners or third-party intermediaries are recommended prior to hiring local personnel and selecting contractors. Such reviews will help foreign companies avoid unpleasant surprises.

Mexican companies involved in the energy sector, transportation, storage, maintenance, security and drilling and with suppliers, particularly those that previously have had contracts with Pemex, represent risks in terms of anti-corruption regulations. While the reform has ended the central role that Pemex used to have in all energy decisions, the scandal involving alleged corrupt contracts by Mexican company Oceanografía, which came to light in early 2014, underscores the need to be wary and take precautions.

A number of firms have worked with FTI Consulting in Mexico to vet prospective partners. In one example, FTI Consulting conducted a reputation due diligence investigation of several individuals and companies on behalf of a global financial services firm. After analyzing public records (including civil litigation databases and indices of regulatory, bankruptcy and tax matters) and media reviews and conducting discreet inquiries with confidential sources, the investigation found that one of the subjects was embroiled in a scandal involving the disappearance of $100 million. FTI Consulting's findings helped prevent the client from engaging in a potentially damaging commercial transaction.

In a second case, a due diligence investigation for a multinational natural resources corporation based in Europe, FTI Consulting discovered that a local Mexican company interested in investing in a joint venture gas exploration project in Tijuana was being investigated for money laundering and arms trafficking.

Rapid Response

Key elements of a successful program to build supportive coalitions and respond rapidly to opposition groups include:

Website resources. It is of particular value to deploy an interactive microsite that will serve as the foundation for an outreach and media interaction campaign and a clearinghouse for compelling facts, figures and information. The site needs to be continuously updated with key collateral materials, social networking and media tools that establish the platform as a go-to source for news, views and credible information on key issues.

New media engagement. Using the website as the central platform, it makes sense to engage key target audiences on the terrain they know, understand and most frequently use. Emerging media opportunities include online social networks such as Facebook and Twitter, RSS, online storytelling and other technologies, as well as continually updated blogs.

Media monitoring and rapid response. Maintain a rapid response "war room" focused on identifying instances of misinformation and correcting facts through direct engagement. The war room also should generate collateral materials such as issue alerts and fact checks and pair that information with an aggressive strategy on letters to the editor, comments, and story development and placement. What appears in the media each and every day must be compiled and responded to, especially in cases of error or misinformation.

Media interaction. It is important to get to know and assist reporters. Have team members in place empowered to speak on behalf of the company. They must be knowledgeable, responsive and relentless in ensuring that the facts are brought to light.

Compelling collaterals. Prepare documents to distribute that present research and messages in a format that is easy to understand and is actionable.

Challenge 4: Security challenges presented by corruption and drug cartels

Corruption and drug-related violence continue to be significant concerns in Mexico. The government sought to address the issue of corruption by including transparent bidding processes and anti-corruption controls in the energy reform legislation. However, even as the authorities have made a strong effort to explain the new rules, the perception of corruption persists. According to Transparencia Mexicana, a non-governmental organization, 71 percent of Mexican citizens polled in July 2014 said they believe corruption has risen in the last two years. In addition, 72 percent of those polled said the Mexican government is ineffective in fighting corruption. Despite investigations by the Mexican Congress into allegations of corruption at Pemex and several of its main subcontractors, the public remains skeptical, understandably so when it reads about a lavish home purchased by President Enrique Peña Nieto's wife from a company holding government contracts.

The government still needs to address how it plans to secure pipelines, zones of onshore exploration, and land bases for deepwater development. Companies that venture into some of the new areas would be advised to develop their own security infrastructure and plans.

Above all, the activity of violent drug cartels most definitely colors foreign perception of Mexico. After the previous administration, under President Felipe Calderón, launched a military campaign against the drug cartels, most of the major cartels scaled back on the national level. However, they have continued their activities and violence in local precincts. The cartels continue to control large areas in Tamaulipas, Veracruz, Durango, Michoacán and Guerrero, among other states. To compensate for lower returns on drug trafficking, organized gangs have diversified into extortion, kidnapping and the theft of fuels from Pemex pipelines.

In some parts of the country lacking strong law enforcement, armed self-defense groups have emerged. According to official data from Mexican authorities, these armed groups are active in 149 municipalities in 20 states. Some have links to criminal organizations. The federal government has legalized 74 of these groups. Some have been disarmed.

To confront the latest cartel challenges, President Peña Nieto announced an effort to reform local police forces, frequently underpaid, corrupt and untrained. In early December 2014, he sent a bill to the National Congress to replace the local police force in Tamaulipas, Michoacán, Guerrero and Jalisco with a state police force within two years.

Oil and gas companies have managed risks such as these in other areas of the globe. To address risks in Mexico, companies should:

Conduct due diligence investigations of prospective business partners and other stakeholders. This should be done before attempting to build relationships with government officials.

Assess security risks before starting work. Before initiating operations, conduct a security risk assessment of the local area. Some of the zones with high reserves of shale gas, oil and other hydrocarbons (Tamaulipas, Veracruz, Coahuila) also are the most affected by criminal organizations. Professional security work can assess the risks involved, from physical violence to cyberthreats, and develop a plan to protect executives, workers, facilities and inventory. Security plans should be formulated by gathering relevant information from a variety of sources to help fully understand the threat environment before commencing operations in Mexico.

Provide anti-corruption training for front-line managers. Even large enterprises can tighten internal controls and enhance training to ensure against violations of law and internal corporate policies. This includes anti-corruption training, establishment of a hotline for complaints, and a structure to both ensure compliance and investigate any potential breaches.

Companies doing business in Mexico before the energy reform have implemented security and risk management measures. For example, FTI Consulting has worked with a North American mining company to handle security at a large mining operation located in northern Mexico, carrying out assessments of the security needs in the facility and organizing and overseeing the security plan, from personnel and the physical plant to cybersecurity.

Mexico's energy reform represents a historic opportunity for investors. Security and risk management challenges are not new to large firms operating in the global energy industry. By applying well-established principles to the context in this emerging market, investors can achieve significant returns while helping Mexico build its economy.

Jane Bussey
Managing Director
Forensic & Litigation Consulting
FTI Consulting
Jane.Bussey@fticonsulting.com

Ana Heeren
Senior Director
Strategic Communications
FTI Consulting
Ana.Heeren@fticonsulting.com

Alejandro Orozco
Director
Forensic & Litigation Consulting
FTI Consulting
Alejandro.Orozco@fticonsulting.com

Pablo Zárate
Senior Consultant
Strategic Communications
FTI Consulting
Pablo.Zarate@fticonsulting.com

For more information and an online version of this article, visit ftijournal.com.