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Petróleos Mexicanos

# Global Integrated Oil - Energy Reform in Mexico Opens Up New Era for PEMEX

## RATINGS

## Petróleos Mexicanos

Long-Term Rating	Baa1
Outlook	Stable

## KEY INDICATORS

	9/30/ 2013(L)	12/31/ 2012	12/31/ 2011
EBIT / Book Capitalization	49.9%	57.6%	58.6%
EBIT / Interest Expense	10.7x	14.8x	11.8x
Retained Cash Flow / Net Debt	6.9%	9.4%	10.3%
Gross Debt / Total Capital	119.3%	113.5%	92.8%

Note: All ratios calculated using Moody's Standard Adjustments.

Source: Moody's Financial Metrics™

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## Summary

- » Mexico's congressional vote to end long-held monopoly status for [Petróleos Mexicanos](#) (PEMEX, Baa1 stable), will transform both the national oil company and Mexico's oil industry. The changes are credit positive for PEMEX, holding out prospects for a more focused and autonomous state oil company and a growing oil and gas industry. The changes also provide a framework to attract the foreign capital and technology that PEMEX and Mexico need to reverse the country's stagnant production and increase the company's efficiency.
- » The end of PEMEX's monopoly status and its re-creation as a "productive enterprise," or commercial company, are the most important changes from the new law. The reform also establishes a range of contract structures to facilitate private investment, and has provisions to allow private companies to book reserves, removing a major impediment to earlier attempts to spur private investment in oil development in Mexico.
- » The reform will reduce PEMEX's board to 10 members, with five independent representatives and five government members, with the Secretary of Energy presiding, while the oil workers union will lose its five seats on the board. This major shift in influence indicates that PEMEX will be able to set its own agenda and annual budget without seeking government approval, though the extent of future government involvement in PEMEX remains unclear.
- » Fiscal change will shift PEMEX to a more standard corporate taxation framework in 2014. This shift will be critical for PEMEX's ability to retain more cash flow for reinvestment, increase reserves and production, and eventually reduce its debt and financial leverage.
- » We see the reforms moving forward in 2014 with little chance that they will get derailed. Still, public protests from the left are bound to continue, and implementation risk poses a major challenge, even with the reform's bright prospects. PEMEX's culture and entrenched interests will need to evolve, and more gradualist forces could come into play. The government will need to clarify a whole regulatory framework and the roles and responsibilities of institutions such as the National Hydrocarbons Commission, the finance ministry and the energy ministry.

## Mexico Ends PEMEX's State Oil Monopoly

Both houses of Mexico's Congress and a majority of the state legislatures passed an historic energy reform bill in December 2013 that will re-make [Petróleos Mexicanos](#) (PEMEX, Baa1 stable) and Mexico's oil industry. The changes are credit positive for PEMEX, even though the reform will end its monopoly status that dates from 1938, holding out prospects for a more focused and autonomous state oil company and a growing oil and gas industry. The changes also provide a framework to attract the foreign capital and technology that PEMEX and Mexico need to reverse the country's stagnant production and increase the company's efficiency.

President Enrique Peña Nieto's PRI party forged a deal with the conservative PAN party after the left-wing PRD pulled out of the Pact for Mexico. The reform amended Article 28 of the constitution, effectively eliminating PEMEX's monopoly status, as well as Article 27, allowing for private sector participation in oil and gas exploration and development. Ultimately, the reform went much further on contract structures than the PRI's original profit-sharing proposal, incorporating the PAN's more expansive demands to attract private investment.

The reform has many features, but most importantly it ends PEMEX's monopoly status and re-creates it as a "productive enterprise," or commercial company, mandated to compete on an even footing with private interests for oil and gas developments. The reform also establishes a range of contract structures to facilitate private investment, and has provisions to allow private companies to book reserves, removing a major impediment to earlier attempts to spur private investment in oil development in Mexico.

## Reform Introduces New Contract Structures

Most surprising is that the reform broadened the structures for private investment well beyond the ruling PRI party's initial proposals. The path to private investment will extend across a range of models, from the pre-existing service contracts to profit sharing contracts to production sharing and licenses. The Secretary of Energy will define the blocks for exploration and development and the type of contract to be offered, while the Hacienda will determine the economic and fiscal terms set out for each contract. The National Hydrocarbons Commission (CNH) will be in charge of putting the blocks up for auction. We also believe the new regime will allow PEMEX to bid independently or jointly with private entities for the blocks.

The PRI originally advanced the profit sharing concept, whereby producers share the risks and development costs of a field, but are only paid in cash, not oil, with no title to or control over the sale of the oil. While perhaps adequate for some lower risk less complex fields, profit sharing was widely regarded as inadequate to attract more widespread interest from major industry players.

Production sharing between the state and private oil company, where the company can be paid in cash and oil, is likely to be more attractive in riskier ventures such as shale or deepwater exploration and development, and will be a key step in PEMEX's ability to attract investment. Finally, a license arrangement appears to be closest to ownership concessions where the producer controls and sells the oil.

Consistent with discussions in earlier stages of the political debate, complex higher-risk developments such as shale oil, the deepwater Gulf of Mexico or even the Chicontepec basin would be governed by production-sharing or -licensing arrangements more likely to attract major oil companies and bring in their technology than the current policy has been. The actual features of the new structures will ultimately be hammered out in the secondary legislation to be developed in early 2014.

All of this leaves PEMEX as a state-owned entity that will retain certain privileges and resource access, but the company would have to adopt the status of a “productive enterprise” within two years. Before that happens, PEMEX will take part in “Round Zero” bidding in 2014 that will allow it to choose and retain a preferential right to certain oil and gas areas, presumably the shallow water and onshore plays where the company has developed expertise over many years.

### **New Law Allows Reserve Booking**

Most significantly, private companies will be allowed to book reserves for their own account in line with US SEC reserve rules. This will remove the biggest impediment to attracting investment from major oil companies, and can only serve to accelerate private investment and energy development in Mexico.

Note that even with the reform, the reserves in the ground remain the property of the people of Mexico through the state. But even if the producer does not technically own reserves at the surface, the reserves can be booked if the producer is exposed to the technical, commercial and environmental risks of production and can reasonably expect to realize the economic benefits of production. So while there may be specific circumstances where reserves cannot be recognized, in most cases the intent will be that producers can book them.

### **Improved Governance Framework Allows PEMEX to Set Own Agenda**

The reform seeks to improve PEMEX's governance and autonomy, reducing the board from 15 to 10 members, to include five independent representatives and five government members, with the Secretary of Energy presiding. The oil workers union will lose its five seats on the board, indicating a major shift in governance and reduced union influence at PEMEX.

The autonomy granted to PEMEX aims to allow the company to set its own agenda and annual budget without needing approval from congress or the finance ministry. The exact direction and extent of future ministry involvement in and approvals over PEMEX remain unclear today.

### **Law Moves PEMEX Towards Standard Corporate Taxation**

Along with establishing the terms of the new oil contracts, fiscal change for PEMEX will be another critical part of the secondary legislation in 2014, transitioning the company to a more standard corporate taxation framework. Substantive fiscal change will be absolutely critical for PEMEX to retain more of its cash flow for reinvestment, increase reserves and production, and eventually reduce its debt and financial leverage.

It is not clear how these changes will play out, but they are likely to include aspects of earlier proposals for fiscal change that were presented in the context of a Mexico's need to broaden its tax base. These included proposals to eliminate most of PEMEX's current tax structure, including the hydrocarbons tax, moving to simple profits tax; replacement of the current 71%-or-higher tax on revenues with a 10% royalty; the establishment of a normal dividend based on earnings and payable to the state; and the ability to write off all oil and gas extraction costs, replacing a current cap on those costs.

## Change Opens Downstream to Competition

The reforms include a number of other notable features, including the establishment of the Mexican Oil Fund, a sovereign wealth fund administered by the central bank. The downstream refining and natural gas pipeline businesses will also be opened to competition and private investment, helping attract capital for much needed expansion of refining capacity and modernization of the pipeline and distribution infrastructure in Mexico. Included in this will be the Energy Regulatory Commission, which will regulate and control permitting for storage transportation and distribution, and the establishment of a National Commission of Natural Gas Control, which will operate the national gas transportation and distribution network.

## Implementation Risk Poses Major Challenge

We see the reforms moving forward in 2014 with little chance that they will get derailed. Still, public protests from the left are bound to continue. The PRD is already pushing for a referendum in early 2014 to throw aside the proposals. Meanwhile, congress will have 120 days after the reforms are signed into law to hammer out the critical secondary legislation that will give substance to the new contract structures and PEMEX's tax regime, among other points.

Although the prospects are bright, implementation risk will pose a major challenge. Change of this magnitude takes time. PEMEX's culture and entrenched interests will need to evolve, and more gradualist forces could come into play. The government will need to clarify a whole regulatory framework and the roles and responsibilities of institutions such as the CNH, the finance ministry and the energy ministry. There is some indication that a first bidding round could take place in 2014, perhaps on deepwater blocks, but it could be well into 2015 before the impact of the new contract structures are understood and a manageable auction queue starts to take place.

## Appendix: Key Metrics and Ratings History

### Petróleos Mexicanos

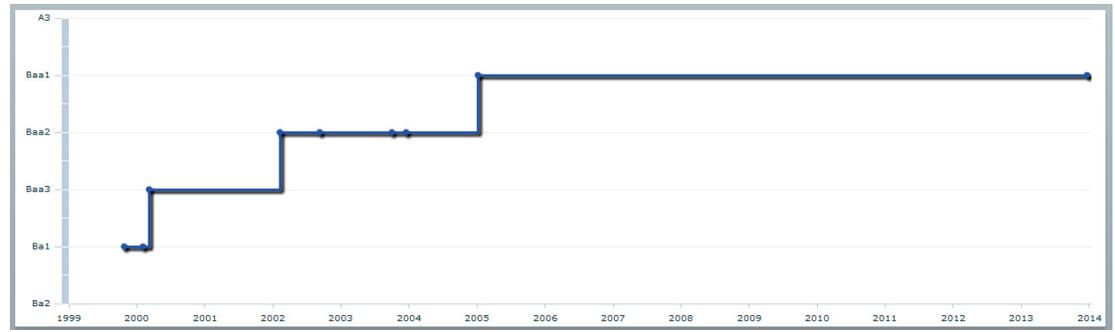
	9/30/2013(L)	12/31/2012	12/31/2011	12/31/2010	12/31/2009
EBIT / Book Capitalization	49.9%	57.6%	58.6%	66.2%	71.2%
EBIT / Interest Expense	10.7x	14.8x	11.8x	6.7x	5.0x
Retained Cash Flow / Net Debt	6.9%	9.4%	10.3%	10.4%	6.2%
Gross Debt / Total Capital	119.3%	113.5%	92.8%	118.3%	134.7%
Gross Debt / Total Proved Reserves	\$11.61	\$11.65	\$8.63	\$8.65	\$8.61
Total Proved Reserve Life (Yrs)	10.4	10.3	10.2	10.1	10.2

Note: All ratios are calculated using Moody's Standard Adjustments.

Source: Moody's Financial Metrics™

## Ratings History

### Petróleos Mexicanos



## Moody's Related Research

### Issuer Comment:

- » [Mexico's Energy Reform Proposal Would Encourage PEMEX Expansion, August, 2013 \(157474\)](#)

### Credit Opinion:

- » [Petróleos Mexicanos](#)

### Industry Outlooks:

- » [2014 Outlook - Global Oil & Gas: Persistent high oil prices keep industry robust, but global supply increasing \(Presentation\), December 2013 \(160568\)](#)
- » [2014 Outlook - Global Oil & Gas: Persistent High Oil Prices Keep Industry Robust, but Global Supply Increasing \(Summary\), December 2013 \(160980\)](#)
- » [Outlook Update, Global Integrated Oil: Start-Up of Major Upstream Projects Will Boost Companies' Operating Cash Flow, November 2013 \(160291\)](#)

### Special Comment:

- » [Energy Conference: High Oil Prices Set to Persist in 2014, Boosting E&P, Midstream and Offshore Drilling Sectors, October 2013 \(159730\)](#)

### Rating Methodologies:

- » [Government-Related Issuers: Methodology Update, July 2010 \(126031\)](#)
- » [Global Integrated Oil & Gas Industry, November 2009 \(121399\)](#)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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