MIDSTREAM Business

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Expanding Mexico's midstream infrastructure requires crossing both figurative and literal mountains. TransCanada employed innovative construction techniques, including rigging a cross-canyon gondola, to build the $600 million Tamazunchale Pipeline Extension, an 81-mile gas line connecting a Pemex terminal with a power plant. *All photos, TransCanada Corp.*

Doing Business In Mexico

Mexico works to change its midstream map from a bare tic-tac-toe board to a bowl of spaghetti.

By Derek J. Anchondo and Armando Gonzalez

The historic legislative reforms from 2013 and 2014 that opened up Mexico's energy and oil and gas industries to foreign investment have brought about many opportunities for companies—foreign and domestic—looking to enter these emerging markets. The upstream sector has opened to private investment by ending the monopoly that Petróleos Mexicanos (Pemex) had, thus allowing for a contractual framework whereby companies can be awarded risk-sharing contracts either with Pemex or directly.

In the midstream sector, the new framework allows Mexico's energy authority, Comisión Reguladora de Energía (CRE), to oversee granting permits for the distribution, transportation and storage of hydrocarbons.

Mexico's state utility, Comisión Federal de Electricidad (CFE), also has an aggressive five-year plan to build natural gas pipelines and infrastructure that would allow Mexico to import 9 billion cubic feet per day (Bcf/d) of natural gas from the U.S., compared to the 2 Bcf/d which flowed to Mexico in 2014 and 3.26 Bcf/d as of mid-2015. First-quarter 2016 U.S. exports to Mexico had risen to about 3.4 Bcf/d and will continue to increase, according to the U.S. Energy Information Administration.

To date, CFE has launched tenders for 24 electricity and natural gas infrastructure projects worth $9.8 billion, which include eight gas pipelines, two wind farms, one combined-cycle generating plant and one geothermal power station—and various transmission projects.

Meeting the demand

As Mexico aims to expand supplies of natural gas, crude oil and electricity to its citizens, the nation will need to expand its midstream infrastructure to meet the increased demand. When compared to the midstream pipeline network in the U.S., the network in Mexico looks like a tic-tac-toe board vs. the bowl of spaghetti seen on a U.S. map.

Construction of the Tamazunchale project, some 150 miles northeast of Mexico City, required boring a tunnel through a mountain to lay the 30- and 36-inch pipeline.

It is important to note, however, that as with other countries that have undergone similar reforms, there is a learning curve for both the companies considering investing in Mexico and the regulators. As such, some of the government agencies are newly created, or have been reorganized, and have been tasked with responsibilities that they are in the process of learning to perform.

Companies have to be flexible in their approach when bidding on the various projects and maneuvering through the regulatory reform process, because those bidding guidelines are being continually redesigned and modified throughout the bid process.

Further, the changes brought about by these guidelines, in addition to the existing challenges in Mexico, have to be taken into account by the companies considering making these large investments, as they will have a significant impact on their projects.

This article discusses some of the major challenges facing companies seeking to invest in these projects and some practical considerations our clients and other companies have used to evaluate and prepare for these challenges.

Land issues

Companies considering infrastructure projects have to ensure that they have a team in place that can thoroughly maneuver through the numerous land issues, such as dealing with indigenous communities, negotiating and obtaining the necessary rights-of-way and validating these deals in court. They should give strong consideration to commencing the due diligence process on the affected land rights at the same time that they are working through the bid process, prior to the selection of the winning bidder, to hedge against potential project delays.

Companies need to get a sense of which routes may provide less of a challenge and which routes will require significant collaboration with the local communities since eminent domain is not as common in Mexico as it is in the U.S. In order to do this effectively, it is important to engage the local stakeholders and agrarian communities, as local activists and protestors could delay a project's timeline or even halt the project if they perceive it will negatively impact their community.

While it is difficult to predict the approximate delay, the due diligence in scoping out the affected communities can help identify whether negotiations with landowners will take three months on the short end, or even one year. If the parties fail to reach an agreement within six months, the pipeline developer may then request government mediation.

However, since this process is part of the new legal framework and has not been fully tested, the regulations and process may not always be clear to the judges.

A successful outreach program can focus efforts on clarifying any potential misconceptions that members of the local community may have about projects, as well as educating and providing the local community with objective information and facts on key issues that may affect their community.

Additionally, the outreach message should explain the positive economic impact that the particular project may bring to their community. Thus, a continuous effort to learn about the communities' concerns, be responsive to these concerns and educate the locals on the benefits that the project will have are important and can result in a smoother and timelier process.

The environment

When considering infrastructure projects in Mexico, the environmental impact of the project is of utmost importance.

When considering gas pipeline projects, for example, the location and design of the pipeline should be closely analyzed well ahead of time to identify the rivers or wetlands that may be crossed, as well as natural, protected areas. Stakeholders, such as indigenous communities, play a very important role in developing the project. In fact, Mexican law states that the indigenous

Meet Mexico's MLP

A new investment vehicle may spur Mexican midstream development.

It is no secret that heavily oil-dependent economies have been staggered by the extended slump in oil prices. As a result, the Mexican government has been forced to identify and implement creative measures designed to compensate for these diminishing economic resources.

One of the most high-profile measures the Mexican government has identified is the infrastructure investment trust, or Fibra E.

In September 2015, the government, through its finance ministry, published new tax rules featuring and regulating this investment vehicle, which will provide the energy and infrastructure sectors exclusive access to private investment for mature, cash-generating projects. To complement the tax regulations, the general provisions applicable to issuers and other stock market participants were further amended in October 2015 to enable the issuance and registration of trust notes for investment in energy and infrastructure in the National Securities Registry, effectively enabling Fibra E trusts as an investment vehicle.

Monetizing assets

The ability to monetize a company's cash-producing assets to attract additional funding will allow companies to acquire crucial resources that will enable them to continue to conduct their activities without interruption. The two companies viewed as the most likely to be in a position to take advantage of this new investment vehicle are Petróleos Mexicanos (Pemex) and Comisión Federal de Electricidad (CFE).

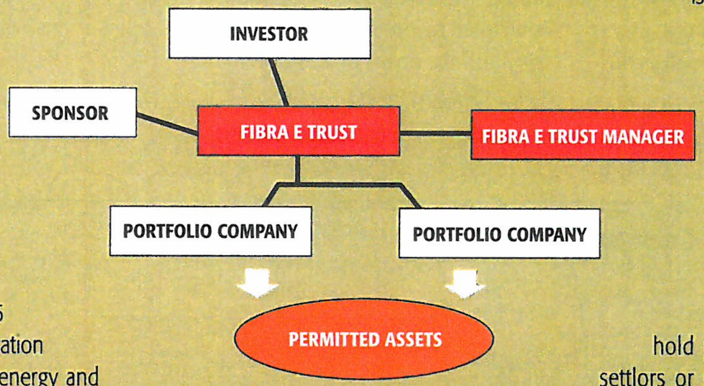
Per government regulations, a Fibra E trust may only invest up to 25% of its resources in new assets—assets within 12 months of being acquired and operated. The remaining 75% of investments must be based upon mature assets—which are currently dominated by CFE and Pemex—since the short-term objectives of Fibra E trusts are to enable monetization of already developed and cash-producing projects.

The new Fibra E trusts share some characteristics of Mexico's already successful fideicomisos de infraestructura en bienes raices (real estate investment trusts, or REITs). However, Fibra E trusts' tax treatment includes unique features that have been influenced by U.S. master limited partnerships (MLPs).

As a result, there are two primary differences from the existing REITs.

First, unlike with Mexican REITS, under Fibra E, companies may not directly own any

Fibra E Trust Structure



of the permitted assets. Instead, the security-issuing trust will acquire shares in companies devoted exclusively to the authorized energy and infrastructure activities permitted by the tax regulations, becoming "portfolio companies." To qualify as a portfolio company, at least 90% of taxable income must be derived from authorized activity in the midstream and downstream sectors, including:

- Treatment, refining, transportation and storage of oil;
- Processing, compression, liquefaction, decompression, regasification, transportation, storage and distribution of natural gas;
- Transportation, storage and distribution of oil products;
- Pipeline transportation; and
- Storage of petrochemicals.

Portfolio companies may also be dedicated to the generation, transmission or distribution of electricity; or infrastructure projects such as toll roads, railways, bridges, telecommunication networks, water and drainage wastewater treatment facilities.

It should be noted that the recognition, surface exploration and extraction of hydrocarbons, as well as their transfer and commercialization, are expressly excluded from the list of permitted activities.

To prevent the potential for double taxation on the portfolio company and investor levels, under the new regulations, portfolio companies as well as the Fibra E trusts will be regarded as pass-through vehicles for income tax purposes.

The second way in which tax treatment will differ from REITs is that Fibra E trusts will issue certificados bursátiles fiduciarios de inversión en energía e infraestructura (energy notes) to be publicly traded in the Mexican stock market and listed on the Mexican Stock Exchange. These energy and infrastructure investment notes will represent the entirety of a Fibra E trust's assets.

As such, distributions will hold priority over amounts owed to settlors or managers of the Fibra E trusts, and energy note holders will be entitled to receive distributions from the trust that could not be below 95% of the Fibra E's and portfolio company's taxable income for that fiscal year. This will ensure that the energy note holders are not prevented from receiving the relevant proceeds from their investment.

Anticipating that few, if any, operating companies meet the requirements to become a portfolio company, the regulations also provide for the possibility of transfers of eligible assets to entities designed to operate as portfolio companies. Such transfers from pre-existing operating companies to newly created portfolio companies will not be treated as taxable transfers if certain requirements are satisfied. ■

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communities that could be impacted by a project must be informed in a consultation process prior to any other authorization that may be required for the project.

In certain cases, it may actually be more favorable not to design the pipeline in a straight line, but a curvier design across certain areas in order to minimize the environmental or community impact and avoid complications and delays. Endangered species, whether they are on the ground or in the air (with wind projects) can also be a challenge, since they involve both the species and their habitat.

With infrastructure projects, disturbing the habitat will also have an impact on the species or on migration patterns. This impact must be duly acknowledged by the project developer, and mitigation measures must be carried out, as Mexican environmental authorities will very likely see to that.

Safety and security

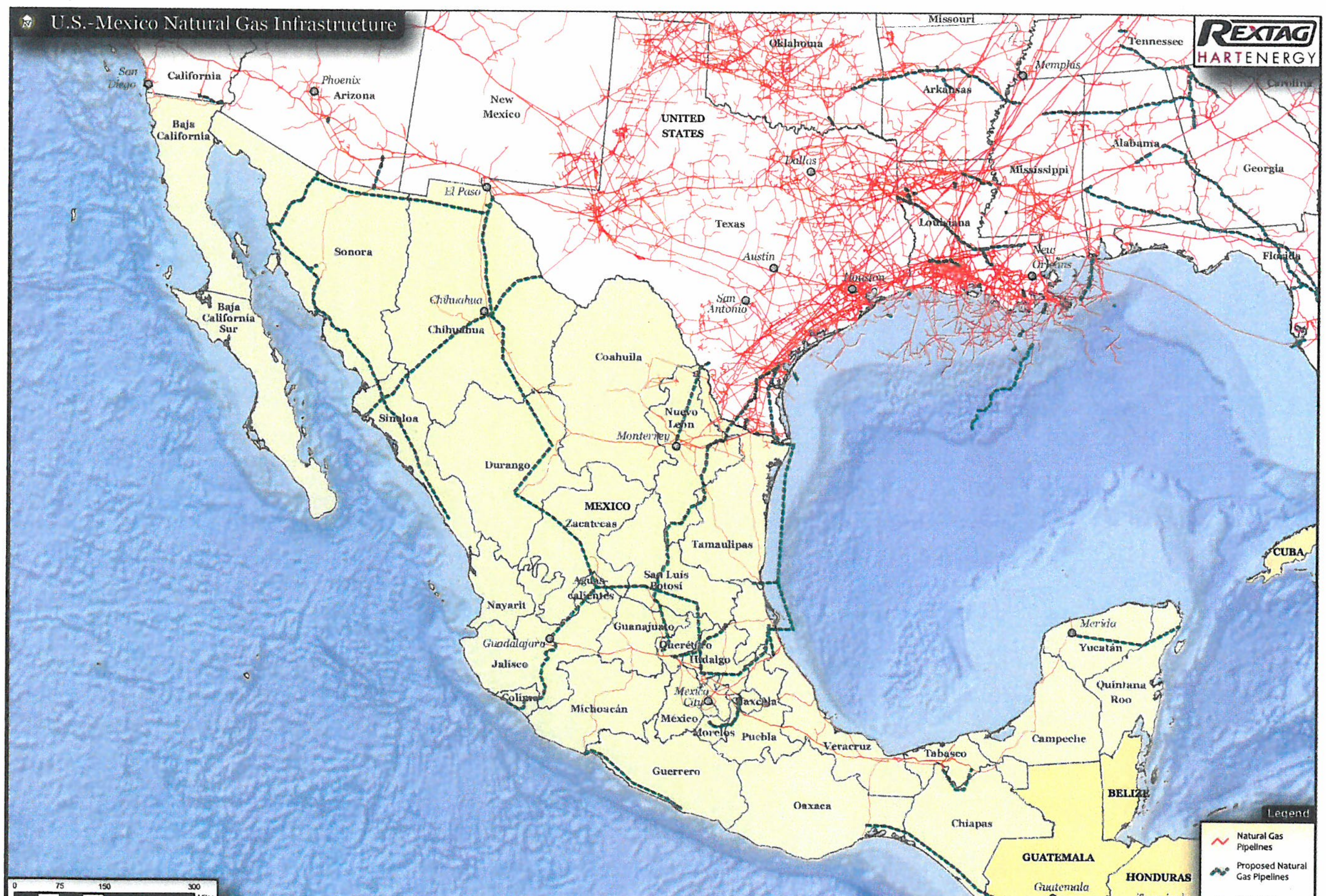
When looking to do business in any country—whether it's the U.S., Mexico or elsewhere—a company will need to consider and analyze the safety and security concerns in that particular country or region. Of course, with pipeline projects that cover hundreds of miles, it is nearly impossible to continuously protect the entire pipeline at once.

Some companies have reported thefts by pipeline tapping. The Pemex director of exploration and production reported the loss of approximately 20,000 barrels per day of crude due to clandestine siphoning in certain months during 2014.

Additionally, President Felipe Calderón implemented Plan Tamaulipas whereby Tamaulipas state on the Texas border was divided into quadrants controlled by operational units of the navy and the army, in addition to the state and local security efforts. The goal was to close routes for this illegal activity and to attempt to decrease the frequency of these encounters, where employees and civilians may be injured and infrastructure damaged.

Some of the current risks and threats faced in Mexico include:

- Destruction of property, equipment and assets;
- Theft of hydrocarbons, equipment and assets;
- Threats to personnel, such as kidnappings, robbery and carjackings;
- Threats from cartels;
- Law enforcement (lack of transparency or corruption);
- Corruption (both public and private);
- Manipulation of resources (people, facilities and resources);
- Civil disruption;
- Cybersecurity; and
- Threats to corporate reputation.



Of course, these risks are not limited to Mexico alone, they must be considered when entering any new country of operation.

A company looking to do business in Mexico should consider issues such as:

- Pre-entry considerations (site selection, staff, local partner selection);
- Moving personnel into and out of the country;
- Driving or other transportation;
- Moving assets (time of day, road conditions and area);
- The supply chain;
- Communication tools (and what to do if mobile phone, email or other communication is not available);
- Check-in programs (and responses if someone doesn't check in);
- Safety and security audits; and
- Kidnapping and ransom insurance programs.

These recommendations are intended to ensure the safety and security of people and assets, preserve the operational integrity of equipment and assets, minimize threats to corporate reputation (and protect shareholder value), limit cost increases, manage risks and enhance community relations. They just make good business sense.

In fact, Mexican law states that the indigenous communities that could be impacted by a project must be informed in a consultation process prior to any other authorization that may be required for the project.

- Offshore vs. onshore operations;
- Office/base location;
- Housing;
- Supply chain and procurement;
- Government and law enforcement; and
- Relations and positions of agents, partners and suppliers.

Be prepared

Companies need to be prepared and teach employees how to think on their feet, what to do if they find themselves alone in a dangerous place, and how to prepare in advance. In particular, companies should consider:

- Networking programs and business insights;
- Security plans;
- Safety and security training programs for personnel (i.e., practice drills);
- Business community contacts;
- Live GPS tracking of vehicles;
- Access to or limitations of use of social media;
- Guards (including, due diligence thereof, outsourced vs. local, the use of weapons and local laws);
- Company corporate policies and guidelines and compliance matters;

Regional differences

The degree to which a company must factor in security concerns—and the associated financial risks to business operations—will largely depend on the part of the country that it is looking to invest in. There are certain parts of the country, such as most of the state of Campeche and the city of Mérida in Yucatan state, with a lot of energy industry activity that are relatively safe.

Of recent concern for energy companies have been certain border towns located in northern Mexico, particularly Tamaulipas, where companies and government agencies are investing in pipeline infrastructure and wind farm projects.

Depending on its corporate make-up, a company operating in Mexico should consider a "safety team" composed of personnel from the departments of quality, health, safety and environment; operations; legal; risk management; safety and security; corporate social responsibility; and supply chain.

Regardless of the location or the scope of operations, the financial risks to the business operations of the various companies operating in higher-risk areas are a critical factor that every company must factor into planning and budgeting.

Midstream opportunities

The expanding midstream sector and related industries continue to provide a host of new opportunities for foreign and domestic companies looking to invest in Mexico. While Mexico has had its share of challenges and will have to continually change some rules in hopes of bettering results in future auctions and attracting more foreign companies to invest in its energy industry, it also has reason to feel confident as it has begun to garner more interest in recent auctions from private investors.

Global companies entering this emerging market need to do their due diligence in order to effectively deal with existing challenges that have troubled Mexico.

Companies need to plan and budget appropriately for the financial risks to the business operations and the safety and security of their employees. Working with a knowledgeable legal and business team that can help a company maneuver the numerous issues associated with midstream infrastructure projects may ultimately dictate the level of success a company achieves in today's promising Mexican energy market. ■

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