President López Obrador and Mexican Energy Reform
U.S. Power and Gas Weekly

Morningstar Commodities Research
8 August 2018

Matthew Hong
Director of Research, Power and Gas
+1 312 244-7649
matthew.hong@morningstar.com

Data Sources Used in This Publication
SENER
U.S. Department of Energy
OPIS PointLogic Energy
Associated Press

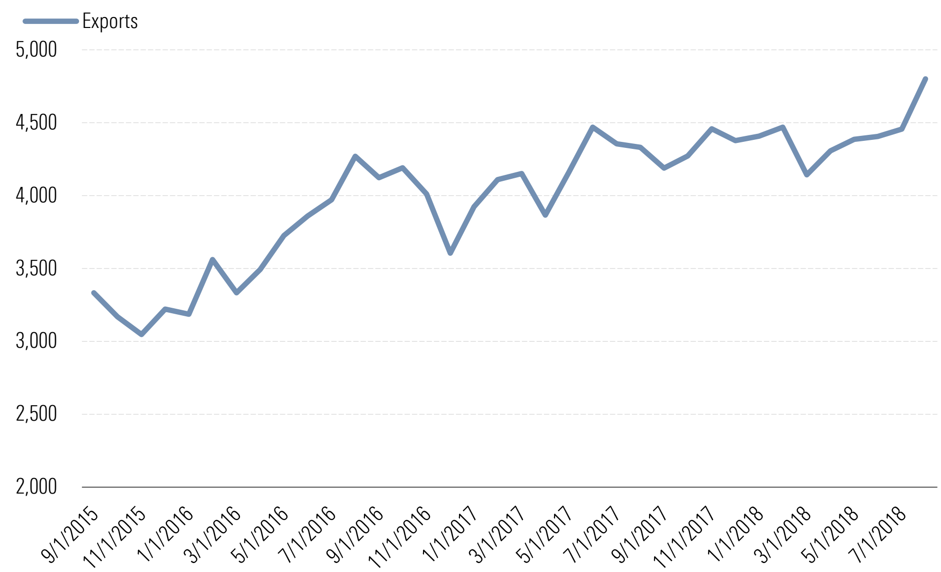
Mexico's Presidential Election
Mexico's President-elect Andrés Manuel López Obrador will be sworn into office this December, marking a transfer of power from President Enrique Peña Nieto's Institutional Revolutionary Party to the National Regeneration Movement. Changes to the constitution made in December 2013 and the signing of secondary laws governing the implementation of energy reform in August 2014, set the groundwork for greater foreign investment and participation in the nation's energy sector. With the passage of these initiatives, Mexico kick-started major market reforms not seen since the nationalization of all private, foreign, and domestic oil companies into Pemex in 1938.

Although the early days of energy market reform saw challenges, the country has seen significant benefit over the last few years from these reform initiatives. However, López Obrador has prioritized being self-sufficient over increasing imports and foreign direct investment, which may provide additional challenges for U.S.-based companies looking to expand south of the border. His plans in the oil industry include upgrading and adding to the nation's refinery fleet and reviewing existing exploration and production contracts, as discussed in an earlier piece titled Slower Mexican Reforms Threaten Refiners. This note will discuss the potential impact of the new Mexican administration on cross border trade for natural gas.

Benefits of Trade
After energy reform implementation began in 2013, Mexico has benefited from greater access to lower cost U.S. supply and capital, which led to an expansion in the country's natural gas pipeline infrastructure. Since market reforms in the energy sector began the country added around 3,400 km. to the domestic pipeline system. Declining oil production resulting from low domestic investment has also had an effect on associated natural gas output, leading Mexico to increase imports from the United States. At the same time expansion of the country's combined generation fleet has increased both domestic demand and the need for imports over the past decade.

Since September 2015, pipeline exports from the United States to Mexico have grown significantly, from 3.3 Bcf/d to 4.8 Bcf/d (Exhibit 1). The growth in exports from the U.S. to Mexico was the primary driver in shifting the U.S. trade balance from a net importer of natural gas to a net exporter of natural gas in 2017. The Secretaria De Energia, or SENER, is expecting natural gas demand to increase by 26.8% from 2016 levels by 2031.

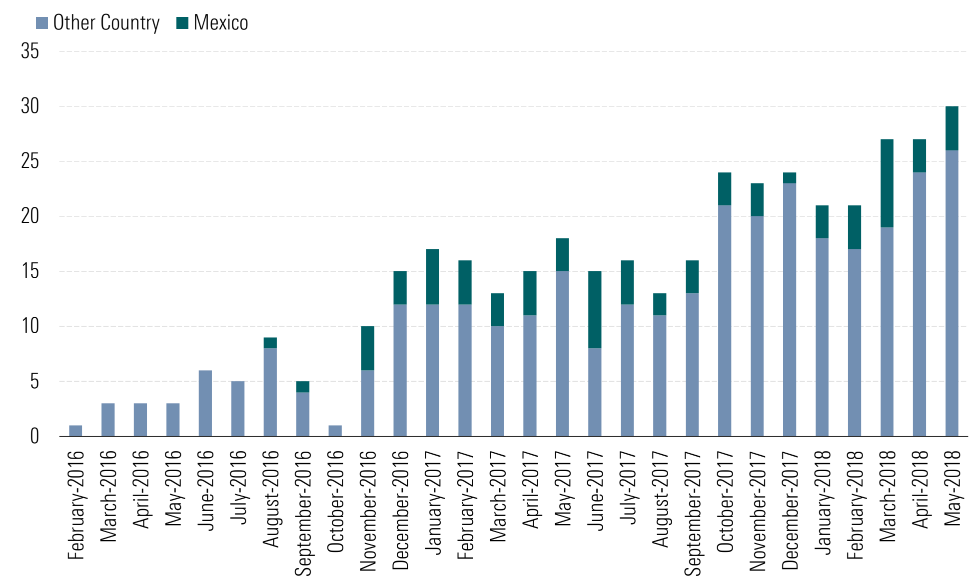
Exhibit 1 U.S. Pipeline Exports to Mexico (MMcf/d)



Source: OPIS PointLogic Energy

On top of pipeline exports of natural gas, Mexico has been the primary recipient of U.S. originated LNG, taking the crown as the number one destination in 2017. Mexico alone accounted for 19% of U.S. LNG exports in 2017 (Exhibit 2). Since January, Mexico has received 22 cargoes from the United States, representing around 17% of vessels exported year to date. In line with the Trump administration's plans to increase U.S. exports of fossil fuels, several large-scale LNG export projects are in varying stages of development, and vessels arriving on Mexico's shores are likely to grow with the expected expansion in U.S. export capacity. Especially if pipeline infrastructure projects inside the country see delays. For example, several of TransCanada's Mexico projects resulted in later in-service dates than originally projected. As operational constraints are resolved on the Mexican distribution system, LNG imports from the U.S. will likely be replaced by higher cross-border pipeline imports, but this is likely to take several years. At the moment, Mexico receives around 13% of its natural gas imports from LNG, and any expansion in U.S. export capacity could further deepen the relationship between the two countries over the short term.

Exhibit 2 Number of U.S. Cargoes to Mexico and Other Countries



Source: U.S. Department of Energy

New Sheriff in Town

López Obrador campaigned this year as a populist, and in previous attempts at the Mexican presidency, showed opposition to the energy reforms carried out by his predecessor. However, many of his positions on energy reform were moderated in the recent presidential campaign. Some of that moderation may stem from the fact that reversing energy reform requires amending the constitution, which, could be difficult.

However, even if the reforms will not be overturned, López Obrador is expected to slow down the pace of change. He has promised to honor existing contracts, but the López Obrador camp has also highlighted the need to be less dependent in the long-term on foreign investment for the oil and gas sectors. This will likely spell fewer outside contracts and a slowdown in energy related foreign direct investment over the next six years.

Although energy reform in general was a hot campaign topic, much of the focus was on the oil sector, and natural gas remained on the sidelines. Some of this may stem from the fact the natural gas pipeline and distribution sectors have been open to private investment since the 1990s. Although, significant development is still needed through much of the country, recent reforms in the gas sector have centered around providing open access to pipelines through auctions and the creation of a market based domestic natural gas index. Nevertheless, López Obrador's preference for a strong state presence in the energy sector may mean delays in the liberalization seen over the past four years.

In line with self-sufficiency, López Obrador has proposed expanding hydroelectricity to reduce Mexico's power sector dependence on natural gas imports from the U.S. In 2016 hydro represented 17.1% of installed capacity. Conventional technology accounted for most of the rest with combined cycles making up the largest share. Mexico has an established target to produce 35% of the country's electricity from clean sources by 2024. Increasing hydro or other renewables would reduce demand for natural gas although the impact on imports remains unclear.

Impact on U.S. Entities

As the new administration takes control at the end of this year, several hurdles will likely appear for U.S. based natural gas entities looking to expand into Mexico. The administration of President Enrique Peña Nieto issued licenses to foreign E&Ps for the first time in July 2017 to develop the onshore portion of the Burgos Basin, which is a shale-rich basin in Northeast Mexico. Further development of this basin requires considerable investment with the U.S. an obvious source of money and know-how. However, despite the opportunity, López Obrador has already vowed to end fracking in a news conference at the end of July, leaving Mexico reliant on conventional gas plays to boost production.

In the same press conference, López Obrador vowed to correct the trend toward private electricity contracts, which he believes is at the expense of the state-owned Comision Federal de Electricidad. Such statements raise doubts about his administration's commitment to respect prior agreements. Absent a clear signal to respect private investment in the energy sector, the risk profile of investing in Mexico may be too high for U.S. capital.

Mexican Leverage

In a letter addressed to President Donald Trump in July, López Obrador proposed a reset in U.S.-Mexico relations, and encouraged a swift conclusion to North American Free Trade Agreement negotiations. Failure to settle trade differences between the U.S., Mexico, and Canada increases uncertainty for U.S. producers looking to export natural gas. The Trump administration has often criticized NAFTA and Mexico; and has not shied away from hitting U.S. trading partners with tariffs. If NAFTA negotiations break down, then tariffs and other trade barriers are likely to materialize.

Global Considerations

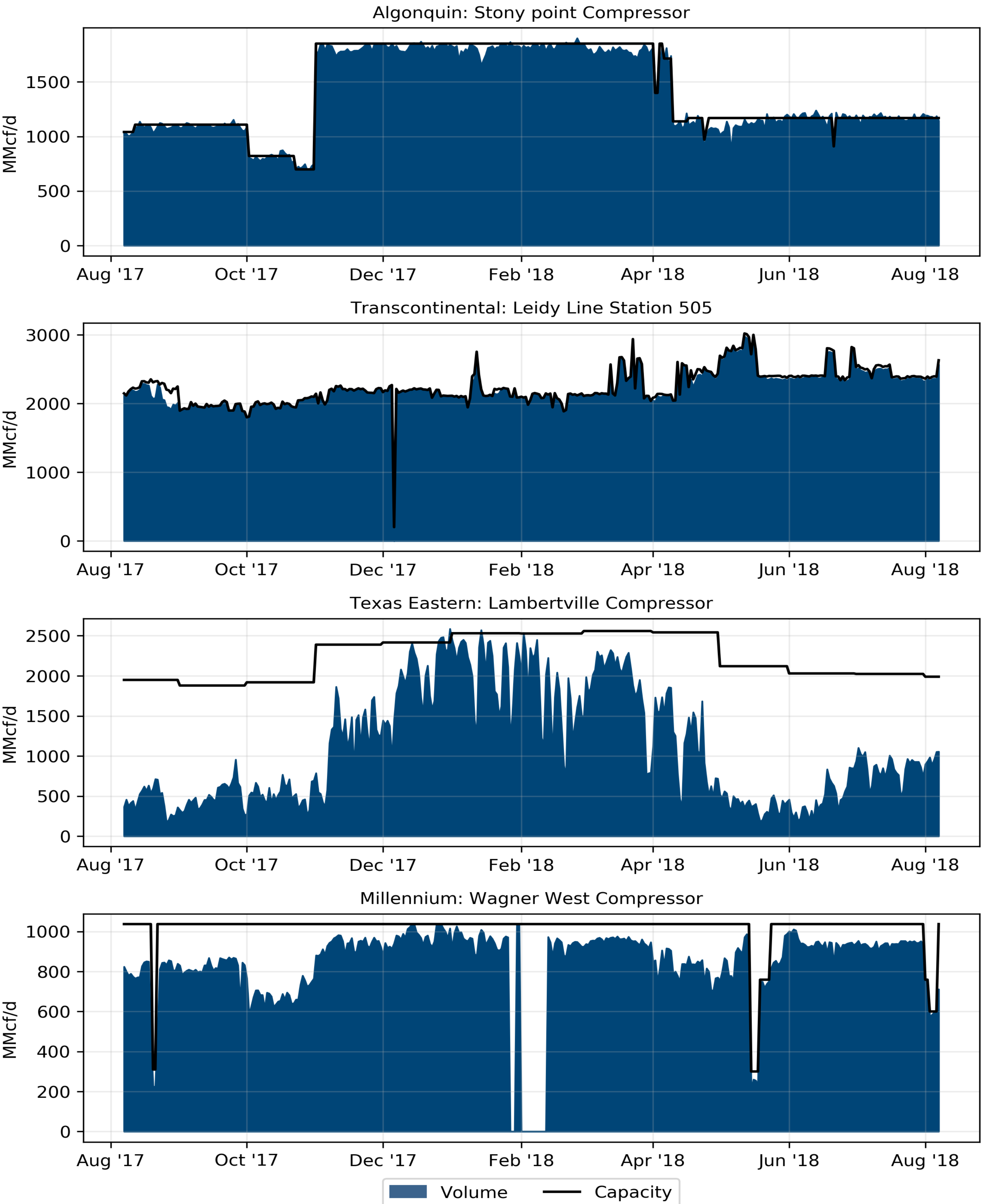
The threat of energy tariffs within NAFTA is only one part of a wider threat to U.S. natural gas producers looking to market growing domestic production in international markets. The further escalation of the trade war with China has led the latter's government to add LNG to the next tranche of targeted products for the first time. Since China is the number two global LNG importer, such a tariff would make U.S. originated cargoes more expensive, impacting investor willingness to commit capital to U.S. LNG export projects.

Growing trade friction with China comes on the heels of the Trump administration intent to cooperate with Europe at the end of July. Although the sentiment was positive, the reality is that U.S. LNG delivered into Europe is currently uncompetitive with closer suppliers like Russia and Norway and is therefore unlikely to replace Chinese demand. The overall trade sentiment does not bode well for an increase in U.S. LNG exports or the expansion of export terminals, especially at a time when several projects are waiting for FID.

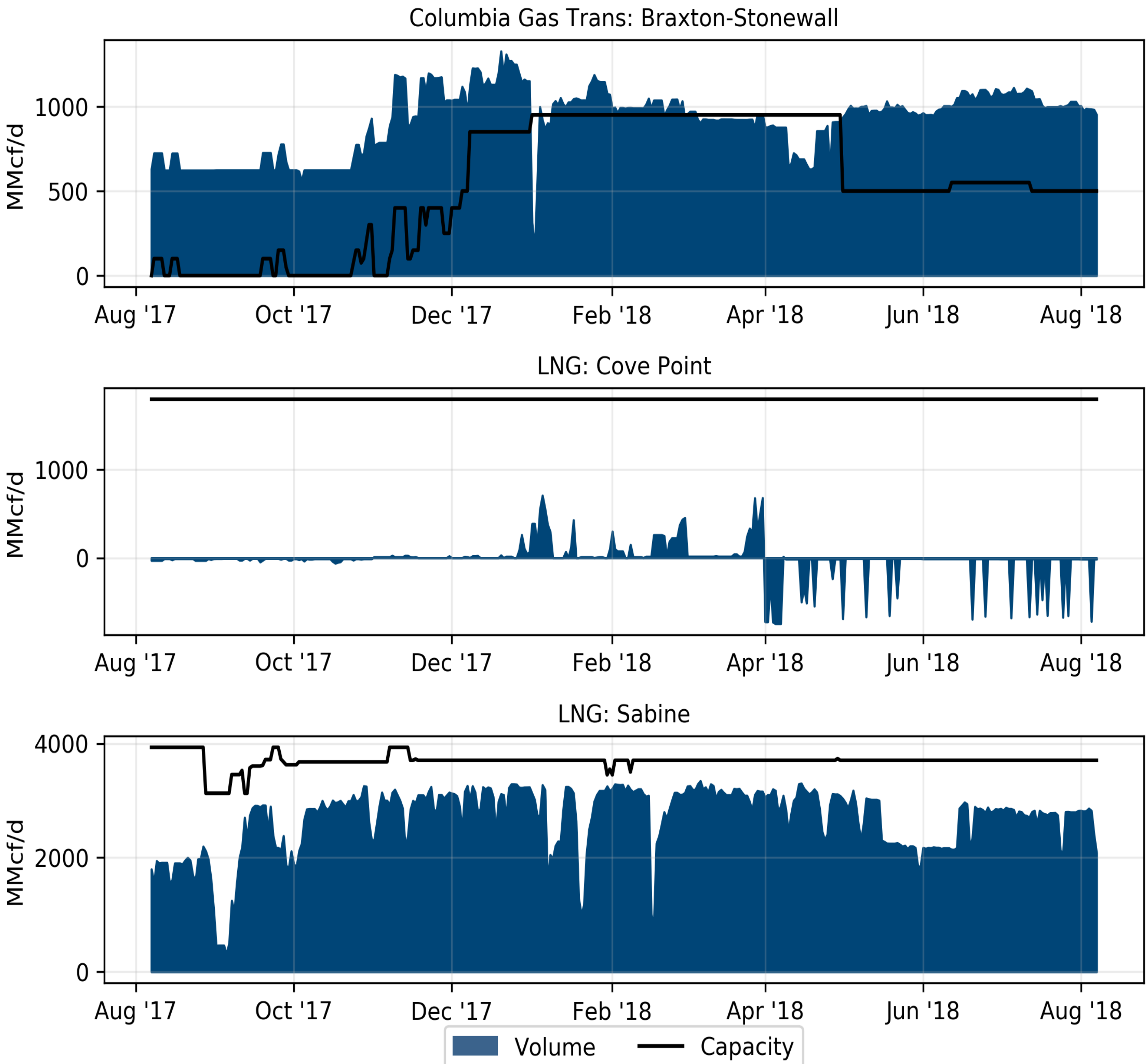
Conclusion

The details of President López Obrador's energy policy remain murky, but changes can be expected. The pace of reform seen over the past five years will slow down as the administration prioritizes domestic solutions over foreign investment. Any delays in infrastructure projects could drive foreign investors elsewhere as the risks and cost of doing business in Mexico increase. U.S. producers, marketers, and midstream investors will need to reassess Mexico's role in their businesses as the policy priorities south of the border become clearer. This need for caution is increasingly echoed in the wider world as trade policies have unintended consequences in international markets.

Natural Gas Important Points



Source: Pointlogic Energy



Source: Pointlogic Energy

About Morningstar® Commodities Research

Morningstar Commodities Research provides independent, fundamental research differentiated by a consistent focus on the competitive dynamics in worldwide commodities markets. This joint effort between Morningstar's Research and Commodities & Energy groups leverages the expertise of Morningstar's 23 energy, utilities, basic materials, and commodities analysts as well as Morningstar's extensive data platform. Morningstar Commodities Research initially will focus on North American power and natural gas markets with plans to expand coverage of other markets worldwide.

Morningstar, Inc. is a leading provider of independent investment research in North America, Europe, Australia, and Asia. The company offers an extensive line of products and services for individuals, financial advisors, and institutions. Morningstar's Commodities & Energy group provides superior quality market data and analytical products for energy data management systems, financial and agricultural data management, historical analysis, trading, risk management, and forecasting.

For More Information

+1 800 546-9646 North America
+44 20 3194 1455 Europe
commoditydata-sales@morningstar.com

MORNINGSTAR®

22 West Washington Street
Chicago, IL 60602 USA