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SPECIAL REPORT: DOING BUSINESS IN CHINA AND LATIN AMERICA

Impending opening of Pemex creates investment opportunities

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Latin America has experienced successive waves of privatization over the past 20 years, providing investment opportunities in sectors ranging from financial services to oil and other natural resources.

The risks of political change and re-nationalization can never be fully discounted as Venezuelan President Hugo Chavez has demonstrated.

However, the region's large commodity reserves in high demand from the global market are driving new investment opportunities in Brazil, Chile, Colombia, Peru and Mexico. The opportunities go beyond mining and drilling to the transportation and financial services infrastructure these nations will need to more fully exploit their natural resources.

Of particular significance is Mexican President Felipe Calderon's proposed multibillion-dollar opening to private investment of the giant state oil monopoly Pemex.

Created in 1938 when the Mexican government nationalized its oil industry, Pemex is the world's sixth-largest crude oil producer and a powerful national symbol. The company produces nearly 2.8 million barrels of crude oil per day and proudly boasts 14.7 billion barrels in proven reserves. Taxes on Pemex revenue account for nearly 40 percent of the federal budget.

With spiking global oil prices, government control of Pemex would presumably be good for Mexico. But declining production and low refining capacity have blunted company earnings, contributing to $20 billion in lost revenue each year.

Pemex's lack of private funding has hampered its ability to modernize and keep pace with industry developments. For example, Pemex has been limited in its exploration of deepwater oilfields, in part because it does not have the technology to drill at depths of more than 1,650 feet. As a result, it has not been able to replace its rapidly shrinking reserves. Over the last three years, production has dropped by 300,000 barrels per day.

At Mexico's Cantarell oilfield, the world's third-largest, production has fallen especially fast. Pemex officials estimate overall production could decline up to 1.2 million barrels per day if private investment is not tapped to boost exploration and drilling.

Refineries pose a problem as well because they are unable to handle most of the oil Pemex produces. As a consequence, Mexico currently imports 40 percent of its gasoline and could end up with a net hydrocarbon deficit within five years.

Petrobras, Brazil's partially state-owned oil company, is broadly seen as a model Pemex will use to open itself to private capital. In less than 15 years, Petrobras has transformed from a company wholly funded by the public into one of the most highly market-capitalized energy firms in the world, largely through joint ventures.

Increased exploration funded by private capital recently allowed Petrobras to overtake Mexico in proven reserves. Capital infusions also allowed Petrobras to make dramatic improvements in efficiency. In 2005, the company produced three times as much oil as it did in 1992 before it opened to private investment without increasing its workforce. The large discovery of oil and gas in Brazilian waters continues to drive investment opportunities.

Although the Petrobras model is highly influential with Mexican officials, Mexico also has its own model for partnering with private investment in the 1995 opening of Pemex's natural gas affiliate. In that model, private investment was structured not through joint ventures but by allowing Pemex to contract with private gas transportation, storage and distribution companies. A bill to amend federal energy laws in Mexico to permit similar capitalization structures for its oil operations is being considered by the Mexican Congress.

Because Pemex would like to double its deepwater exploration budget by seeking $15 billion annually in private funding, a variety of private investment likely will be tapped.

Laws restricting Pemex's ability to partner with private companies do not apply outside of Mexico, so international oil companies like Royal Dutch Shell, which co-owns a refinery in Texas with Pemex, will be well-positioned to bring capital and expertise into Mexican territory.

By improving their capabilities across the region, oilfield service companies are likewise positioning for Pemex's opening and similar opportunities in other Latin American countries.

Even this partial opening to private investment will have a profound effect at Pemex as well as on the general investment climate in Mexico and the rest of Latin America.

The momentum of giants Petrobas and Pemex — both moving in the same direction — cannot be underestimated. Pressure likely will be brought to bear on other Latin American leaders to follow suit and open their oil and natural resource sectors to private investment.

It has taken Pemex 70 years to avail itself of market forces. With natural resources at the forefront, the impending opening of Pemex is positioned to lead a new wave of investment opportunity across Latin America. ■

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