Latinvex
Latin America Business News & Analysis

April 18, 2017

AMLO Threats: The Practical Challenges

Practical challenges faced by Lopez Obrador in reversing infrastructure projects and energy reforms.

BY LARRY PASCAL AND EDUARDO CORZO

The presidential election campaign in Mexico is well underway and Mexicans will vote for their new president on July 1 and consider these three main candidates, among others: (1) **Andres Manuel Lopez Obrador** from the political party Morena, (2) **Ricardo Anaya** from the PAN, and (3) **Jose Antonio Meade** from the PRI. Left of center Lopez Obrador, who is running for President for the fourth time, holds a distinct lead in the polls and investors are closely watching his policy statements during the campaign to assess the impact of a possible Lopez Obrador election win on the general business environment and their investments in particular. Two issues come to mind – the proposed Mexico City International Airport and the Mexican oil and gas reforms – particularly, the current and future investments by upstream oil and gas companies in the sector after a 70-plus year prohibition on private investment was lifted as part of the reform package passed in the early stage of the Enrique Pena Nieto Administration.

Without private investment, Mexican state oil company Pemex would have to increase its exploration and production budget to US$19.3 billion from US$7.4 billion per year. (Photo: Pemex)

Changes to New Proposed Mexico City International Airport Site

President **Enrique Pena Nieto** announced in 2014 that the new airport would be located on existing federal land in the Federal Zone of the Texcoco Lake between Ecatepec and Atenco in the State of Mexico and approximately 10 km northeast of the current airport, Benito Juarez. The design for the new airport is to have one large terminal of 6 million square feet and six runways phased in over time. Construction is estimated to take approximately eight years. The architects are Sir Norman Foster and Fernando Romero, the son-in-law of Carlos Slim. Recently, Grupo Aeroportuario de la Ciudad de Mexico, which is the state-owned concessionaire overseeing the airport's development, raised approximately US$1.6 billion for the new project, which is the country's largest FIBRA E trust offering.

Notwithstanding the progress on the country's most important transportation infrastructure project, Lopez Obrador has stated during the presidential campaign that if he is elected, he will move the proposed Mexico City airport to another location, asserting that the land for the current proposed airport site is not appropriate for such use. In fact, like other international airports in large metropolitan areas (e.g. London Heathrow), the development of a new Mexico City International Project has posed a challenge for several Mexican administrations. President **Vicente Fox** tried unsuccessfully to develop a new airport in the Texcoco Basin approximately 20 miles outside Mexico City, but was thwarted by angry peasant farmers who refused to sell at any price and threatened violence. As a result, the existing Benito Juarez International Airport (also known as AICM), which was opened in 1915 and is located in a densely populated area, continues to operate at capacity and its approximately 45 million annual passengers regularly suffer delays.

The Alternative Lopez Obrador Mexico City Airport Proposal

Lopez Obrador's alternative proposal is to preserve the existing facilities of AICM (Terminals 1 and 2), use them only for domestic flights, and build two new runways and presumably terminal facilities at the Military Air Base of Santa Lucia, which would be intended for international flights and air cargo. The new project would purportedly cost 69 billion pesos (approximately US$3.8 billion at current exchange rates) compared to the 170 billion pesos (approximately US$ 9.4 billion) investment estimated to be required to build the new international airport announced by President Pena Nieto. Although an environmental impact study has been prepared for the alternative Lopez Obrador proposal, neither a cost-benefit analysis nor a technical feasibility study has been made public.

One of the main environmental risks of the Lopez Obrador proposal is that the new airport would damage the fragile water tables that currently exist in the area. **José Luis Luege Tamargo**, a former head of Mexico's National Water Commission (Conagua), recently described the effect of the proposal as "catastrophic."

The current planned airport enjoys broad industry support. The International Air Transport Association (IATA) has given its support to the construction of the new airport site identified by the Pena Nieto Administration to replace the current slot controlled airport. The current airport serves approximately 47 million passengers annually, almost 50 percent over its design capacity of 32 million passengers. **Federico Patiño**, the chief executive officer of Grupo Aeroportuario de la Ciudad de México says project cancellation would cost about 120 billion pesos (US$6.6 billion) in third party damage claims.

In addition, the National Chamber of Air Transportation (Canaero) opposes the Lopez Obrador suggestion to hold a technical panel in order to analyze the viability of the construction of the New Mexico City Airport. Canaero insists the suspension or cancellation of the current airport project would limit the country's air connectivity, increase airline operating costs and jeopardize airlines' financial viability plans in the face of the commitments already acquired for the renewal of fleets and new venues in the new Mexico City International Airport. Aeromexico, the largest AICM tenant, , which only recently entered into a strong Alliance with Delta Air Lines and gave up coveted slots in order to win approval of its alliance, would almost surely be prejudiced by the separation of domestic and international operations and the loss of connectivity in its largest hub city.

Nevertheless, Lopez Obrador has tried to assuage investors and contractors that all contracts will be honored and somehow assigned to the new airport (other than contracts tainted with corruption). However, it is hard to imagine that such a position would prevail in light of the new project requirements and site.

Investments in the Oil and Gas Sector (Current and Future)

Lopez Obrador also has called into question the Mexican energy reforms, the granting of upstream oil and gas contracts to private companies (foreign and domestic), and the importing of refined fuels into Mexico rather than investing in additional Mexican refining capacity, signaling that changes would be forthcoming under his administration if he were elected. The rationale for the Mexican energy reforms was pretty clear – Mexico’s oil and gas production was rapidly declining with the maturation of the Canterell Oil Field and the failure to develop comparable replacements. PEMEX was very inefficient as an operator of oil fields and in fairness was deprived of the necessary resources by its sole owner, the Mexican State, to reinvest in technology to develop both the refining capacity of the country and new oil fields, including the deep-water field in the Gulf of Mexico. Moreover, its largest historic export market, the United States, was undergoing a shale revolution that would diminish its need for Mexican oil in the future. Finally, the Mexican State was highly reliant on proceeds from PEMEX for over one-third of its national revenues, putting in jeopardy important social spending and infrastructure projects based on the fluctuation of a commodity.

Under the Mexican energy reforms, the National Hydrocarbons Commission (CNH) has held thirteen (13) bid rounds since the new legislation, and a total of 107 contracts have been awarded. The CNH is an autonomous agency with independence from the Ministry of Energy, and the CNH’s commissioners are appointed by the President of Mexico with approval of the Senate. Taking advantage of corruption scandals that have affected the PRI in the last few years, Lopez Obrador has vowed that his administration will review the current E&P awarded contracts to ensure transparency and the equitable terms for both the contractor and the Mexican government. For the future bid rounds, it is not clear if Lopez Obrador would continue the program or to the contrary suspend all public procurement related to onshore and offshore blocks.

Regardless of the future direction of the oil and gas bid rounds, the legal support for the award of the upstream contracts to dates is ample, including the Mexican Constitution (principles of "legal certainty" and public procurement under Articles 14, 16 and 134), the Public Works Law (applicable to the Mexico City airport project) providing the rules for public procurement and legal regime of public contracts, the Hydrocarbons Law, and the applicable bidding guidelines (applicable to the Mexican Energy Reform).

Of course, the legal regime and foundation of the public contracts awarded under the Mexico City airport project and the CNH bid rounds, is not exempt from government review for failure to abide by its terms or if they were procured improperly. Such contract disputes would presumably have to be resolved in Mexican courts or before arbitration tribunals. Moreover, Mexico recently ratified the ICSID Convention and this creates a more secure environment for investors to pursue claims against the Mexican government in the event of a contract breach by the government, unjustified/arbitrary contract termination, or expropriation.

The Future of the Oil and Gas Sector

Notwithstanding the existing awarded contracts, the bid rounds for future blocks may be suspended by any incoming president. A new Mexican President could even try to reverse the recent reforms, but this would be a complicated process requiring amending laws and possibly the Mexican Constitution again, which would require a large majority in the Mexican Congress.

Lopez Obrador has campaigned on ending imports of cheap fuels, increasing production at local refineries, and strengthening PEMEX. An important adviser to Lopez Obrador, **Rocio Nahle Garcia**, has commended the PEMEX-Shell joint venture at the Deer Park Refinery in Texas, and suggested Mexico should turn its focus to value-added fuels, and processing crude domestically to produce more gasoline and diesel at refineries owned by PEMEX. Clearly, PEMEX could invest more in the downstream sector, but this is a very capital intensive segment of the oil and gas sector, and widely viewed as less lucrative (although it would generate new employment). However, the reason Mexico imports 75 percent of its gasoline from abroad is that the six PEMEX Mexican refineries operate at less than half their capacity. In fact, Mexico's refineries are at their lowest production rates in 27 years.

The International Energy Agency (IEA) recently determined that without the energy reform and private sector participation, Mexico would produce 2.3 million b/d by 2040 and receive 45 percent less in oil revenue over the coming decades compared with 3.4 million b/d under the energy reform outlook. Without private investment, PEMEX would have to increase its exploration and production budget to US$19.3 billion from US$7.4 billion per year today over the coming decades to fulfill IEA's reform production forecast, according to Pulso Energetico, a think tank backed by Mexico's Hydrocarbon Association. More likely, Mexico's oil production would flatten if the incoming President halted future bid rounds. It is unlikely PEMEX would be able to materially increase oil and gas production at its current funding rates, given its technology and other resources. For an incoming President faced with the prospect of limited resources, he/she would have to assess the merits of diverting much needed spending on social projects and infrastructure to make PEMEX a national champion once again.

Conclusion

Any incoming Mexican President would critically review large projects approved by an opposition party President and Lopez Obrador has made no secret of his intentions in this regards. However, he many come to appreciate practical impediments he may face. Cancellation of the New Mexico City International Airport would surely implicate billions in possible exposure to the state-owned airport concessionaire and industry and possibly environmental opposition to his new site. Benito Juarez Airport (AICM) is operating above capacity, resulting in extensive passenger delays, and landing and takeoff patterns result in substantial flying over heavily populated areas, causing environmental harm.

In the oil and gas sector, Lopez Obrador can slow down or entirely halt new bid rounds and focus more of PEMEX's resources on refining and storage. However, once again, full-fledged termination of validly awarded upstream contracts would come at a sizeable cost in damages to those energy investors, plus likely downward pressure on the Mexican peso, making borrowing a more expensive proposition for the State and leaving less for necessary state spending. In addition, expropriation steps would damage the country's favorable international reputation as being open for foreign investment. More modest steps could be achieved and enable the new President to achieve more legislative objectives.

Larry Pascal and Eduardo Corzo are members of the Haynes and Boone Mexico Practice Team based in Dallas and Mexico City, respectively. Carlos Alva of Haynes and Boone Mexico City also assisted with this article. They wrote this article for Latinvex*.*