Testimony before the Texas Senate Natural Resources Committee

Friday September 19, 2014
Chair: Senator Juan Hinojosa

Introduction

Chairman Hinojosa and distinguished members of the Committee, thank you for inviting us to provide testimony related to your interim charge to examine the economic impact of Mexico's energy reform on Texas' economy. My name is Nathaniel Karp and I am an Executive Vice President at BBVA Compass and Chief U.S. Economist for the BBVA Group. Marcial Nava is a Senior Economist at BBVA Compass. We want to note that the testimony presented today represents our own views and does not necessarily reflect the views of BBVA Compass or BBVA Group.

Let me begin with a brief overview of BBVA Compass and Mexico's energy reform. Then I will present our major findings on the economic impact this reform will have on the Texas economy. In short, Texas will benefit from more than 200,000 jobs, almost $3.4bn in state revenues and $45bn in GDP.

Background

BBVA Compass is among the top 25 commercial banks in the U.S. based on deposit market share. It ranks 4th in Texas. Our bank is part of BBVA Group, a global financial services group that operates in 30 countries and has $843 billion in assets and 110,000 employees. BBVA is the second-largest financial institution in Spain and has leading franchises in South America. BBVA Bancomer is the largest bank in Mexico.

BBVA Research produces timely and relevant analyses for the Group on global developments, market-moving changes in local economies, and shifts in industry trends and technology. Our economists interact with policymakers, media outlets and the public through seminars, presentations and publications. With a leading position in Texas and Mexico, we at BBVA pay close attention to both of these economies and are well prepared to provide you with insights on today's topic.

Mexico's Energy Reform

In December 2013, Mexico's Congress passed groundbreaking legislation that modified the Constitution to effectively open up the energy sector to foreign and domestic private investors. The reform seeks to modernize the energy sector, reverse declining production, and lower energy costs, which in turn would increase economic growth.

By renovating existing agencies and creating new ones, the reform improves the regulatory framework, curtails discretionary practices and enhances transparency and accountability. This should lead to a more competitive environment for the energy sector.

Nine new secondary laws and changes to 12 others lay a foundation of private sector participation. These laws govern licenses, production-sharing and profit-sharing contracts, and pure service contracts. This will allow private investors to engage in exploration and production, and participate in the refining, transportation, storage and distribution of oil, natural gas, and other petroleum-based products. The reform will also allow the government to contract with private firms to expand the generation, transmission and distribution of electricity.

The 21 laws also address matters of eminent domain, the taxation and royalty system, operations and financial reporting by energy sector entities, the functioning and interaction of regulatory entities, and domestic content requirements.

State-owned companies Pemex (Petróleos Mexicanos) and the Federal Electricity Commission (Comisión Federal de Electricidad-CFE) will be transformed into so-called state-owned productive enterprises. They will be granted autonomy and their corporate governance will be strengthened. This will increase revenues, create economic value and boost their competitiveness against their peers. Although the Mexican state retains ownership of all subsoil hydrocarbons, state-owned productive enterprises and private firms will be allowed to report reserves for accounting and financial purposes.

In addition, the reform creates the Mexican Oil Fund, entrusted with receiving, administering and distributing income from all hydrocarbon exploration and extraction activities, excluding any tax revenues.

Lastly, the reform encourages the use of renewable technologies, sets ambitious goals for clean and renewable sources, and expands industrial safety and environmental protection.

The reform's implementation is moving swiftly. Recently, the government finalized what's known as Round Zero, assigning exploratory blocks and producing fields to Pemex while previewing the blocks that will comprise Round One. Over the next 12 months, Pemex has committed to migrate 22 contracts to the new legal scheme and seek out partners for 10 projects assigned in Round Zero.

Regulators are also planning to set up a "data room" for a transparent and open bidding process. It will publish the pre-bidding packages, carry out social-impact studies, sell the bid packages and execute the new contracts of Round One. As a result, Mexico's energy sector could soon see increased capital spending and a boost in new technologies.

Opportunities for Texas

Texas stands to be the major beneficiary from the reform due to deep economic ties, geographic proximity and expertise in energy exploration, production and distribution. Texas is home to hundreds of energy companies, 28 of them in the Fortune 500. Considering that 54% of prospective oil and gas resources in Mexico are unconventional, involving horizontal drilling and fracking, the country will need Texas' firms to provide physical resources, cutting-edge technologies, human capital and expertise. Likewise, Mexico will require vast amounts of capital and engineering capacity to drill in deepwater, which accounts for 52% of its total conventional reserves.

There is also considerable potential for expanding shale gas exploration and production in Mexico. Mexico's total gas resources are one-fourth of the U.S. Of its five promising basins, the two largest are on or near the Texas border. The Burgos Basin in northeast Mexico — an extension of the Eagle Ford Shale — is estimated to hold two-thirds of Mexico's 545 trillion cubic feet (Tcf) of technically recoverable shale gas resources. This would have significant appeal for companies that operate on the Texas side of the Eagle Ford play.

Currently, 80% of Mexican gas imports come from the U.S., and 60% of those come directly from pipelines in Texas. Before the reform, the Mexican government expected natural gas imports from the U.S. to more than double — from 1.8 billion cubic feet per day (Bcfd) in 2013 to 3.8 Bcfd in 2018. In the shorter term, these estimates are unlikely to change significantly given that new shale gas production in Mexico will take time to develop. Over a longer horizon, despite higher gas production in Mexico, Texas gas will continue flowing to Mexico as stronger economic growth in the country will lead to higher demand for electricity, which is increasingly generated by natural gas. In addition, Mexico offers opportunities for LNG exports to Asia.

Advantages also extend to companies in the construction sector as the reform will drive a need for new infrastructure. Over the next 10 years, Mexico needs to increase electricity capacity by 60% to keep up with increasing demand. Moreover, Mexico has less than 1 mile of pipeline per each 1,000 square miles of land, one-ninth the U.S. ratio.

Economic Impact on Texas

To better understand the economic impact of Mexico's energy reform on Texas between 2015 and 2018, we can separate it into three stages:

First, a large share of the foreign direct investment (FDI) to Mexico will be used to purchase goods and services from Texas. Our estimates suggest that energy-related FDI to Mexico will increase gradually, reaching $20bn per year in 2018. Assuming current trends for trade between Mexico and Texas, which accounts for 45% of total U.S. exports of goods to Mexico, incremental FDI will top $50bn, of which $10bn will be used for importing Texas goods and services. This will benefit a wide range of manufacturing industries including, but not limited to, manufacturing of electrical equipment, motor vehicle parts, mining machinery, chemicals, oil products, engines, turbines, and power transmission equipment, medical equipment, electric lighting equipment, and computer and peripheral equipment. In addition, we expect a significant boost in activity for professional, scientific, and technical services, insurance carriers and depository institutions.

Second, gains in Texas energy-related companies will boost incomes and spill-over into other industries such as housing, durable goods manufacturing, retail trade, and recreation. This in turn will create more jobs and boost tax revenues for the state. In total, we estimate the primary and secondary impacts on Texas will be $10.5bn in additional economic activity, 132,000 jobs, and $2.1bn in tax revenues.

Third, on average, Mexico will grow by an additional 0.8% per year due to the reform. Stronger growth will raise living standards and real incomes, which will further boost trade with Texas, creating new opportunities for individuals and companies on both sides of the border. This tertiary effect will generate $34.9bn in incremental economic activity in Texas, add 84,900 jobs and raise state revenues by $1.3bn.

In total, Texas will add 217,000 jobs, state revenues will increase by $3.4bn and GDP by $45.4bn. This is equivalent to an additional 42 basis points of real GDP growth per year on average.

For South Texas, developing the shale basins south of the border together with the high level of economic integration with Mexico's northeast will boost economic activity by $5.6bn and increase employment by 40,300. South Texas and the Mexican states of Tamaulipas, Nuevo Leon and Coahuila have a combined GDP of more than $300bn. If the energy reform adds an extra 1% to real GDP growth, the region would generate $60bn in additional economic activity during the next 10 years. Faster economic growth at the border will narrow the socio-economic disparities between Texas' border cities and big metro areas. If these border towns effectively seize the opportunity, the Texas-Mexico border could see one of the most dramatic transformations in its history.

Assumptions

Our estimates assume a sustained increase in oil and gas production, a smooth adoption of new technologies and the absence of geopolitical shocks. In addition, we assume an effective implementation of the reform, which requires policymakers to create efficient regulatory entities, attractive contracts and a competitive tax structure. The impact of the reform would be stronger if Mexico manages to reduce the cost of doing business by investing in human capital, strengthening the rule of law, fostering competition, modernizing infrastructure and improving security, as well as reducing economic informality, inequality and poverty.

Conclusion

In conclusion, Mexico's groundbreaking energy reform is a win for Texans. Higher economic growth, greater foreign trade, more state revenues and job creation will bring prosperity to our communities and help solidify Texas' position a leader of growth and innovation in the 21st century.

We will be glad to answer any questions at this time. Thank you very much.