

THE NEWSLETTER OF THE BDO NATURAL RESOURCES PRACTICE

NATURAL RESOURCES RECORD



CAPITALIZING ON MEXICAN ENERGY REFORM IN 2015

By Jerry Seade, Rafael Ortiz and Bill Penczak

For nearly 10 years, Mexico's oil revenues have fallen as production has deteriorated among many of its offshore and onshore fields. Yet the country's outlook remains bright, with its natural resources industry experiencing a flurry of legislative activity over the past 18 months to open its vast oil resources to foreign investment. Mexico's Energy Reform Act, passed in 2013, overhauls the Mexican energy industry and, in particular, the oil & gas market, in several key ways:

- It grants regulatory authority to several Mexican governmental agencies, including the Energy Regulatory Commission, the Secretary of Energy and the National Hydrocarbon Commission;
- It creates the new National Agency of Industrial Safety and Environmental

Protection and the Mexican Petroleum Fund to address safety and environmental matters while managing cash flows;

- It introduces four different contractual arrangements (production sharing, profit sharing, services and licensing agreements); and
- It provides Pemex, Mexico's national oil company, greater autonomy, allowing it to retain more resources to make smart future investments and operate more efficiently.

Mexican President Enrique Peña Nieto has made it clear that this legislation does not represent the privatization of Mexico's oil assets; rather, it is a strategic move intended to optimize Mexico's estimated 156.6 billion barrels of oil equivalent (BOE). (By way of comparison, the Permian Basin is estimated to have reserves of about 23

DID YOU KNOW...

At press time, **Mexico's Ministry of Energy** said 38 companies have expressed interest in the country's shallow-water exploration blocks since announcing the invitation for bids in December 2014.

Brent crude prices dropped by 48 percent in 2014 after three years of the highest average prices in history, says **Bloomberg**.

BDO's 2015 Energy Outlook Survey reports that shale will be a priority in the coming year, with 47 percent of CFOs planning to increase their investment in the sector.

Compared with 3.6 million barrels a day in 2014, the **International Energy Agency** forecasts the U.S. shale oil supply will jump to 5.2 million barrels a day in 2020.

Oil and gas senior executives polled by **Pearson Partners International** anticipate a strong five-year outlook for the sector; 76 percent of participants expect their industry segments will perform significantly or moderately better, and 83 percent predict their individual company's performance will improve.

The third annual **Sustainable Energy in America Factbook** reports that investment in the clean energy sector has totaled \$386 billion since 2007 and increased by 7 percent in 2014 from 2013's levels.

▶CONTINUED FROM PAGE 1

MEXICAN ENERGY REFORM

billion BOE—meaning Mexico could serve as a key international supplier of oil & gas for decades to come.) With oil earnings providing an important source of revenue for Mexico—accounting for nearly one-third of all government revenues in 2013, according to the U.S. Energy Information Administration—these legislative measures are poised to provide meaningful, robust growth opportunities not only to Mexico's energy sector, but also to U.S. companies looking for smart, long-term investments.

THE BENEFIT POTENTIAL

Pemex has reported that in August 2014, the Mexican government awarded it 96 percent of the country's estimated proved crude oil and natural gas reserves and 31 percent of prospective reserves in what is known as the Round Zero bid. Round One bidding, expected to occur early this year, will permit private and potentially other non-Mexican governmental enterprises the opportunity to bid for new acreage. Despite the current malaise in oil prices, many U.S. companies remain interested in competing for these assets, as they believe Mexico represents a mid-to long-term investment play.

Round One, as well as future bidding rounds, are engineered to increase oil production in the short term. Contracts that will be tendered during these bidding rounds include: A) the fields and/or blocks that Pemex has received as entitlements, which will be migrated into contracts, and B) new exploration or extraction areas that were not requested by or granted to Pemex.

Partnering with such enterprises allows Pemex improved access to resources, technology and capital it would not otherwise have at its disposal to help grow its business and accelerate its activities. For example, new offshore and non-conventional drilling techniques could help further develop the Cantarell and Ku-Malooop-Zaap offshore fields, as well as the Boquillas Formation, the southern continuation of Texas' Eagle Ford shale. For U.S. investors, these partnerships and contracts grant them access to the new frontier of the North American energy boom.

KNOW BEFORE YOU GO: KEY POINTS FOR ENTRY

Though the potential return on investment for U.S. companies partnering with Pemex appears promising, organizations contemplating a play in the "new" Mexican oil & gas market should carefully consider all attendant tax, accounting and risk management matters prior to involvement. While this is by no means a complete checklist, the following reflects a number of considerations U.S.-based exploration & production (E&P) and oilfield services companies should have top of mind as they evaluate entry points in Mexico's natural resources sector:

1. Tax Structure

For U.S. companies considering a play in the Mexican oil and gas market—whether as a direct investment, joint venture or alliance—it is vital to establish the right corporate structure to protect investments,

preserve cash flows and ensure profits can be repatriated back to the United States in a tax-efficient manner. The four types of contracts Mexico's energy reform legislation introduced will grant parties different rights and obligations. In order to optimize a company's tax position, the appropriate corporate structure will most likely depend on the contract used. Organizations should consider the tax implications of each structure as part of the planning and due diligence process.

Furthermore, the use of income tax treaties to reduce withholding taxes, transfer pricing principles to price the transfer of goods and services, and funding mechanisms to facilitate cash flow are additional factors that should be taken into account when developing the corporate structure.

2. Booking Reserves

One area of particular interest for companies exploring Mexico's markets is the treatment of reserves related to Mexican plays. While all oil & gas products will technically remain property of the Mexican state, companies will be permitted to disclose reserves in their financial statements for accounting purposes under production sharing and licensing contracts.

These changes are noteworthy for U.S.-based public companies, which heretofore have not been able to book these reserves, with further trickle-down benefit to the public and private companies providing services to the E&P sector. By including these reserves in an organization's valuation, investors will be able to anticipate an E&P company's ability to grow and generate revenue, as well as determine the potential return on equity for shareholders.

3. Risk Management

As with any foreign operation, companies investing in Mexico's oil & gas sector must take a proactive approach to financial and regulatory risk management. Areas of concern include, but are not limited to:

- **Commodity price fluctuations:** Oil price volatility is a given for the global natural resources sector. Companies and investors can leverage derivatives to protect their investments from sudden or sustained declines in commodity prices. (However,



►CONTINUED FROM PAGE 2

MEXICAN ENERGY REFORM

these same derivatives may also prevent companies from fully benefiting from future increases in prices.)

- **Currency fluctuations:** Despite a recent decline of the Mexican peso against U.S. dollar as of late, the peso's overall value has grown by 20 percent over the past decade. Again, companies may want to consider using hedging instruments to protect their long-term capital investments from future volatility or a widening gap between currencies.
- **Internal controls:** As with any foreign operation, having strong internal controls in place for operations and financial reporting, particularly in partnerships or joint ventures, is critical. They act as a prophylactic against fraud and can help moderate the risk of financial reporting errors.
- **Liabilities:** Companies should maintain robust international insurance coverage for unexpected accidents or hazards, including injury to workers or potential environmental contamination.
- **Legal risks:** The new and complex Pemex contract processes are nascent and subject to change. Businesses should consider engaging legal counsel at the outset of any new investment or project to facilitate adherence to the contract's terms and to ensure that all parties stand to benefit from the partnership.

THE FINAL WORD

Despite the underdevelopment of Mexico's energy assets over the past several decades, the current government has made significant strides in sourcing much-needed technology, capital and expertise from foreign companies to grow its oil & gas sector. Equipped with a firm situational understanding of the new reforms and a well-developed game plan to help mitigate risks, U.S. companies are poised to not only bolster the Mexican energy industry, but also to see a solid, long-term return on investment.

For more information, please contact Jerry Seade, International Tax Partner with the Natural Resources practice, at jseade@bdo.com, or Rafael Ortiz, Assurance Partner with the Natural Resources practice, at rortiz@bdo.com. Bill Penczak, Executive Director, Market Strategy at BDO USA, can be reached at bpenczak@bdo.com.

BDO SPOTLIGHT:

Executive Q&A with Bernardo Soto, BDO Mexico



How did you become interested in your line of work, especially your work in the natural resources industry?

I first became interested in auditing after taking a course on the subject as part of my Public Accounting studies at Instituto Politécnico Nacional (National Polytechnic Institute, IPN). I found the work exciting and could see myself building a career in it, so post-graduation, I began working for a small, local Mexican audit firm. I later joined one of the Big Four accounting firms as an external auditor. At first, my assignments were not industry-specific; however, on one occasion, I had the opportunity to audit a Mexican public mining company, and I immediately took a liking to the natural resources sector. As my career progressed, I continued to develop my interest by overseeing audits for numerous mines in Mexico, Canada and the United States. By the time I joined BDO Mexico as an audit partner in 2003, I had cultivated significant knowledge of the Mexican natural resources industry and was appointed the lead engagement partner for Petroleos Mexicanos (also known as PEMEX), the national oil company of Mexico.

What do you see as the biggest challenges facing the natural resources industry today?

Mexico's oil and gas industry is in the midst of massive changes as a result of the 2013 Energy Reform Decree, an amendment to the Mexican constitution that restructured the country's national energy companies and opened the sector to private investment. In addition to this, the amendment enacted a broad variety of reforms, including transforming PEMEX's subsidiaries into state-owned subsidiaries, and creating new entities to manage the drilling process, logistics, cogeneration and

services, fertilizer production and ethylene production. Any reform of this scale is bound to pose challenges to affected industries, and it is forcing the Mexican oil and gas sector to navigate uncharted territory.

On an international level, the natural resources industry must grapple long-term with challenges related to environmental regulation, as well as the immediate issue of fluctuating commodity prices. Fracking remains controversial, and the cost of compliance is likely to rise as more and more governing bodies adopt regulation related to the safety of fracking, its use of water and the management of environmental pollutants created throughout the process.

Meanwhile, the oil and gas sector must also navigate industry volatility as supply continues to outpace demand and drive down oil prices globally. The growth of the North American energy sector has no doubt been important for improving the global economy and has the potential to address a wide variety of energy needs worldwide; it was also responsible for helping to stabilize global commodity prices as conflict continued to shut in oil production from the Middle East. However, as Middle Eastern producers begin to ramp up production again, we're seeing the industry struggle to reorient. Oil businesses everywhere are revisiting their strategies to ensure that they maintain their long-term prosperity in the face of short- to medium-term oil price declines.

What are some of the biggest growth opportunities in the industry?

Though industry growth has introduced a variety of challenges, there lies tremendous opportunity in pursuing innovative approaches to addressing these obstacles. The sector

▶ CONTINUED FROM PAGE 3

BDO SPOTLIGHT

is creating numerous new jobs, and in the process, is helping to shape a new, more modern workforce with a range of in-demand technical skills. In addition, the success natural resources companies are experiencing right now is allowing them to make critical investments in new technologies that will help scale production, create efficiencies, improve market access and lessen the environmental impact of operations.

What lies ahead for BDO Mexico?

BDO Mexico is poised to grow its work in the Mexican oil and gas industry as a result of the 2013 reforms, which are continuing to take shape across the country. We are working hard to stay ahead of these changes and help our clients negotiate a rapidly-changing landscape. Moreover, we hope to continue cross-border collaboration with other BDO member firms, including BDO USA—which has been an important part of our work with PEMEX—as well as member firms throughout Latin America.

How would you describe the impact of the work you do? How do you create value for clients?

We aim to proactively anticipate and address the needs of our clients as their industries continue to evolve. We're constantly educating ourselves on important industry developments and looking for creative options to target our clients' challenges, whether that's understanding the potential impact of a new environmental regulation or helping them navigate international tax regimes. In short, we seek to be trusted advisors to our clients and help them achieve their business goals.

Bernardo Soto, Assurance Partner with BDO Mexico, can be reached at Bernardo.Soto@bdomexico.com.

PEerspective in Natural Resources



Private equity investors seeking stable, emerging markets in which to invest are turning to Latin America, reports [Oil & Gas Financial Journal](#). While these countries have historically lacked the resources to fully exploit the region's vast hydrocarbon reserves, there exists an opportunity—in both upstream and midstream—for private equity firms to provide the necessary capital to update or build out energy infrastructure.

Colombia, which is in the process of updating its pipeline network after production surges strained the existing infrastructure, is one potential area of investment. Recently, a consortium of investors led by the International Finance Corporation (IFC), a member of the World Bank Group, announced a \$320 million investment in Pacific Midstream Ltd. to help the firm improve Colombia's energy infrastructure. The IFC hopes an improved pipeline network will result in lower transportation costs and foster new investment in the country.

Exxon Mobil recently made a new shale oil and gas discovery in southwestern Argentina, which could open up potential new investment opportunities in the upstream sector. The country has an energy deficit and large untapped reserves, and financing is beyond the reach of state-controlled energy firm YPF, according to [Reuters](#). However, Argentina is one of the few Latin American countries—along with Venezuela and Cuba—that retains economic controls that limit foreign investment, according to [Oil & Gas Financial Journal](#). This, along with low oil prices, could serve as a deterrent.

However, private equity firms may also see the low oil price as an advantage when weighing the benefits of investing in Latin America's oil and gas sector. Global crude oil prices have more than halved in the last six months, and [Reuters](#) suggests both multinational companies and smaller

players will likely be forced to sell assets in order to maintain their balance sheets. Companies looking to snap up acquisitions in the natural gas and oil sector may have the chance to do so at bargain prices.

Similar to the transformative shift taking place in Mexico, Brazil's mature market and strong fundamentals have captured investors' interest. However, the country's current economic woes—a threatened credit rating, as well as high inflation and unemployment rates—are testing some investors' resolve. Yet private equity firms remain committed to their investments in the region. Carlyle Group recently raised a new fund for Brazil, and Advent International acquired three Brazilian companies last year. In addition, [The New York Times Dealbook blog](#) reports that General Atlantic backed the country's only IPO in 2014, despite a weak economy.

Opportunities for IPOs in Brazil are expected to remain scarce in 2015 due to the country's sluggish equities markets, but M&A activity is expected to be on a par with last year, according to [Reuters](#). Last year saw robust dealmaking related to spinoffs, de-listings and debt restructurings, a trend that is expected to continue. With a stagnant economy and a 12.5 percent drop in the Brazilian real last year, asset prices are low and spreads are narrow, which will continue to draw interest from foreign companies and private equity firms in 2015, Fábio Mourão, Credit Suisse's head of Brazil investment-banking told [Reuters](#) in January.

Overall, it appears that Latin America will continue to be a hot area of investment as private equity firms look to capitalize on these emerging economies and grow their international reach.

PEerspective in Natural Resources is a feature examining the role of private equity in the natural resources sector.

BDO USA GROWS ITS FOOTPRINT IN TEXAS

BDO USA IS PLEASED TO ANNOUNCE THE EXPANSION OF ITS TEXAS PRACTICE, GROWING ITS PRESENCE IN BOTH THE HOUSTON AND DALLAS MARKETS. THE EXPANSION WILL BE INSTRUMENTAL IN GROWING BDO'S NATURAL RESOURCES PRACTICE.

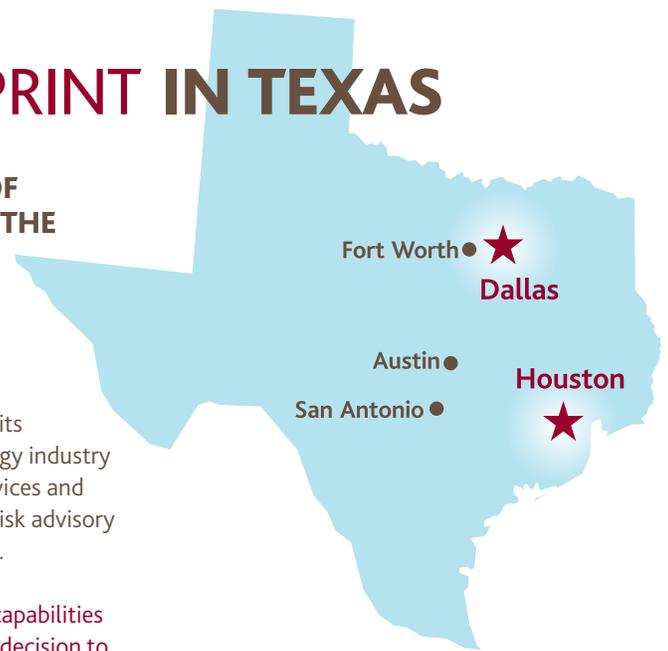
"BDO has long maintained a strong presence in the Southwest, anchored by thriving offices located throughout Texas, including Houston, Dallas, Fort Worth, Austin and San Antonio," said **Southwest Assurance Regional Managing Partner Jay Duke**, who also leads BDO's National Industry Programs. "As the U.S. energy industry has continued to grow, so have our clients' needs—and we're here to grow with them. We're confident that our expansion will position us to better serve our clients across all segments of the energy value chain."

In addition to deepening the bench of professionals prepared to serve energy clients,

the expansion helps BDO grow its experience across multiple energy industry segments, including oilfield services and utilities. It also bolsters BDO's risk advisory service offerings to the industry.

"Combining our resources and capabilities with those of BDO was an easy decision to make," said **Texas Managing Partner Ron Martin**, who is among the professionals recently joining BDO. "Together, we offer a full suite of customizable services and tools to assist clients from upstream to downstream."

BDO USA has been serving the energy sector for more than 100 years, with boots on the



ground across the United States—including in Texas, Alaska, Colorado, Oklahoma, New Mexico and Louisiana. It is also an active participant in BDO International's Global Natural Resources Group, working with BDO member firms worldwide to provide cross-border services to multinational clients.

MARK YOUR CALENDARS

The following is a list of upcoming conferences and seminars of interest for natural resources executives:

MARCH 2015

March 22-26
43rd Howard Weil Energy Conference
Roosevelt Hotel & Convention Center
New Orleans

March 30 – April 1
2015 Appalachian Basic NGV Expo
Civic Center
Charleston, W.Va.

APRIL 2015

April 6-7
Energy Capital Conference
Omni Barton Creek
Austin

April 12-15
Gas Processors Association Annual Convention
Marriott Rivercenter
San Antonio

April 20-22
IPAA Oil & Gas Investment Symposium
Sheraton Hotel & Towers
New York

April 20-24
CERAWeek 2015*
The Hilton-Americas
Houston

April 27-30
Southwest Energy Institute
Seward County Community College
Liberal, Kan.

MAY 2015

May 7-8
Oil and Gas Public Relations and New Media Conference
Gaylord National Hotel
National Harbor, Md.

May 12-14
90th International School of Hydrocarbon Measurement
Cox Communications Center
Oklahoma City

May 20-22
2015 MLP Investor Conference*
Hyatt Regency Orlando
Orlando

* Indicates that BDO representatives will be present at the conference.

BDO'S NATURAL RESOURCES INDUSTRY PRACTICE

BDO's Natural Resources industry practice provides assurance, tax and advisory services to emerging and established businesses in the United States and all over the world who are involved in both the traditional and alternative energy industries. Our clients often operate across borders either raising capital or making acquisitions abroad. Our extensive industry knowledge is supported by our international network of 1,328 offices in 152 countries, allowing us to provide a consistently high level of service wherever our clients do business.

ABOUT BDO USA

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, financial advisory and consulting services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through 58 offices and more than 400 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multi-national clients through a global network of 1,328 offices in 152 countries.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms. For more information please visit: www.bdo.com.

Material discussed is meant to provide general information and should not be acted on without professional advice tailored to your firm's individual needs.

© 2015 BDO USA, LLP. All rights reserved.

For more information on BDO USA's service offerings to this industry, please contact one of the following regional practice leaders:

CONTACT:

CHARLES DEWHURST, Houston
713-986-3127 / cdewhurst@bdo.com

KEVIN HUBBARD, Houston
713-986-3149 / khubbard@bdo.com

RICHARD BOGATTO, Houston
713-407-3723 / rbogatto@bdo.com

TOM ELDER, Houston
713-407-3959 / telder@bdo.com

LANCE FROELICH, Houston
713-986-3186 / lfroelich@bdo.com

VICKY GREGORCYK, Houston
713-407-3955 / vgregorcyk@bdo.com

ROCKY HORVATH, Houston
713-986-3150 / rhovath@bdo.com

JIM JOHNSON, Dallas
214-665-0614 / jwjohanson@bdo.com

RAFAEL ORTIZ, Houston
713-986-3176 / rortiz@bdo.com

CLARK SACKSCHEWSKY, Houston
713-986-3101
csackschewsky@bdo.com

CHRIS SMITH, Los Angeles
310-557-8549 / chsmith@bdo.com

ALAN STEVENS, Dallas
214-665-0786 / astevens@bdo.com

JIM WILLIS, Houston
713-986-3115 / jwillis@bdo.com