



Insights of the Energy Sector Leaders

Introduction



With over 70 contracts signed and committed investments for 77 billion dollars, the Energy Reform in Mexico continues going forward. The first results reveal the consistency of the market and promise to boost an industry that will generate jobs, promote economic development, and provide a stable source of income for public finances.

The Energy Reform undertaken three and a half years ago began in a discreet manner; however, those first steps, in which different authorities and specialists set out to negotiate, design, and build the legal framework for new investments, proved to be highly profitable.

Throughout these years, the best international practices in the field have been adapted to the infrastructure and regulation of Mexico. In this way, the State will receive a very significant oil income and share with private companies the industry-inherent risks, particularly in deep water fields.

Institutions such as the National Hydrocarbons Commission, the National Natural Gas Control Center, or the Wholesale Electricity Market, among others, have been key to the energy sector opening being conducted in an orderly, efficient, and transparent way.

After the first set of tenders (rounds Zero and One), in which the participants bid for various blocks and confirmed interest in subsequent tenders, it is fair to say that the opening of the sector reveals enormous interest and strengthens the attractiveness of the country in a turning point in the bilateral relations with the United States, that has as background the modernization of the North American Free Trade Agreement (NAFTA).

At KPMG, we took on the task of gathering the perspectives of industry leaders to respond to the most pressing concerns, as well as to demonstrate that the Energy Reform is a fact and, after having borne its first fruits, moves a step further in its consolidation, which stands out as a great opportunity for the development of our country.

Sincerely

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The balance of the Energy Reform



Exploration, production, storage and distribution companies and new gas station brands have boosted the energy sector with committed investments for 77 billion dollars.

In just over three years, the energy industry has opened up to the technological contributions, innovation and investments of national and international companies interested in taking advantage of the attractive opportunities offered by Mexico.

From the first tenders, which included blocks on land, shallow and deep waters, the industry has incorporated 66 exploration and production companies (33 of them Mexican), 58 more dedicated to the storage and distribution of natural gas and fuels, and 18 gas stations brands, several of which have started operations in different parts of the country, according to Energy Ministry (SENER).

In total, medium and long-term investments of 77 billion dollars have been committed, and additional contributions will be made based on bids scheduled for 2017 and 2018. In Round 2.4, 30 contract areas will be auctioned with 4.2 billion barrels of crude oil equivalent (BBOE) in prospective resources. Just for the geological study of the concession fields, 20 specialized companies have invested more than two billion dollars, and the Energy Ministry claims that the Mexican part of the Gulf is the world's area with the largest 3D seismic research.

The results are clear: two companies benefiting from the first contracts have reported concrete findings in the Amoca

and Zama fields, off the coast of Tabasco, with a potential of three BBOE, representing an 11 percent increase in the country's reserves, and 70 percent of the profits generated will be assigned to the Mexican State.

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As pipelines and storage centers are put into operation, hydrocarbons inventories will increase by more than 50 percent, according to the SENER. This availability will promote the installation of industries in regions that lack infrastructure, and improve energy security by reducing the risk of product supply shortages. With market-adjusted prices, competition and internationally recognized transparency, the opening up announces the recovery of oil production and exports, as well as greater efficiency in the electricity market and a strong boost to other industrial sectors.

Mexico - Chile and its adherence to the IEA

The incorporation of Mexico to the International Energy Agency (IEA) is a significant step for the energy sector, as it will optimize its efficiency and boost the country's economy based on best practices.

Last June the Mexico application for membership was accepted so, once formalized by the Mexican government, our country becomes the 30th member of the International Energy Agency, a specialized and autonomous body of the Organization for Cooperation and Development (OECD).

The IEA, founded in 1974, brings together the largest energy consumers, such as the United States, Germany, France and the United Kingdom. To achieve its incorporation, Mexico has met requirements such as the opening of the sector to promote competition and the free market.

One of the main objectives of this incorporation is to promote energy security and monitor markets so that suppliers conduct themselves in a clear, stable, and sustainable way. In recent years, environmental and energy efficiency issues have been added, as well as the diversification of clean and renewable sources.

The IEA has lobbied when the global or regional gas or oil supply has been compromised or when speculation on energy prices affect the economy of its member states. The IEA

publishes statistical information on the current and predictable energy output, changes in demand and price fluctuations. It offers strategic counseling, shares good practices and helps countries define a functional energy mix according to their needs.

Members of the IEA have been attentive to the boom in shale oil production in the United States, conflicts in the Middle East, as well as the gas crisis between Russia, Ukraine, and the European Union. They have also warned of growing oil demand in the Asia-Pacific region, which limits supply and affects import-dependent countries such as Japan and other European nations.

In the case of Mexico and Chile, the IEA will provide information and consultancy for developing an efficient energy generation and acquisition policy, including natural gas or liquefied petroleum gas and gasoline, as well as to meet economic development needs. In addition, both countries could take advantage of the experiences of other nations for the rational management of clean energies, such as solar and wind energy.





Anti-corruption practices: A must for the industry

Organizations have the responsibility to use all the available legal and regulatory means to create effective anti-corruption programs that foster transparency in their business processes.

It is the responsibility of energy sector players to have all the corporate, ethical and legal resources for adopting anti-corruption practices throughout their processes, from exploration, transportation and refining, to the production and commercialization stages. Today, there are companies that have become a standard because of the compliance programs they have designed to manage risks effectively.

In Mexico, in July 2015, the Anti-corruption National System (SNA, for its acronym in Spanish) was created, which comprises legal tools of value to the companies, such as the General Law of the SNA, which aims for the generation of prevention, detection, investigation and approval programs.

Likewise, there is the General Law of Administrative Responsibilities, which addresses the expected behavior of public servants, as well as of individuals and legal entities. Article 25 of this law helps enterprises understand where to start to generate an anti-corruption program.

To achieve this goal, it is necessary to rely on compliance and investigation areas, as well as disciplinary control units that constitute an “internal advocacy office,” empowered to fully identify risks through the following processes:

- Prevention to establish incident probabilities based on local and international regulations;
- Detection to follow-up and verify corruption complaints;
- Analysis and monitoring to bear in mind possible conflicts of interest;
- Training for encouraging contractors to comply with the regulatory framework of the contractual authorities; and
- Sanctions to punish acts of corruption carried out by those who put the company’s reputation at risk.

Transparency is one of the core values in all of the energy-sector organizations’ supply chains. Therefore, the generation of effective anti-corruption programs must have its root on company leadership: corporate structures have to be led by ethics and integrity of all business processes.

Oil revenue, taxation and compliance



In three and a half years of Energy Reform implementation in Mexico, companies and regulators had faced challenges in terms of contract assignment, tenders, oil revenue, taxation and compliance of local content.

For the first time in over eight decades, the private sector has become involved in contract assignment and permits for hydrocarbons exploration and extraction. This path has required the establishment of rules, as well as ongoing learning for optimizing a new model for both enterprises and institutions.

Mexico had faced several challenges regarding contract assignment, tenders, oil revenue, taxation and compliance of local content in this three and a half year period since the Energy Reform was implemented.

Certainly, the taxation of the new oil contracts and the implementation of a special administration by Mexico's Tax Administration Service (SAT for its acronym in Spanish) have been central themes for authorities.

Establishing parameters in oil contracts in terms of the minimum percentage of goods and services originated or produced within the country, known as local content, as well as the mechanisms for verifying compliance, has been

an issue to which the authorities have paid special attention, given that the responsibility to develop the sector's supply chains is now shared by public and private operators.

This new energy landscape has implicated a paradigm shift, with the special challenge of convincing players that this new context will allow Mexico to obtain a better use of its energy resources.

There have been other challenges, most notably meeting the requirements for obtaining the necessary drilling permits (most of which were received just days before the exploration process began), and maintaining a fluent and effective relationship with regulators.

Other challenges to be faced by the industry includes oversight. The authorities will be very cautious when it comes to reviewing in oil contracts concepts such as: cost structures, transfer pricing, intangible service and input costs, financing, interest rates, application of international treaties and hydrocarbon E&P depreciation rates.

Deepwater E&P activities



It is a great opportunity for private companies that the State has opened upstream activities; however, internal and external factors are limiting the ability of organizations to participate fully in this sector.

Deepwater, especially in terms of upstream, is one of the most mediatic issues of the Energy Reform. For years, international companies based in Mexico had operated under contracts with the productive State enterprise, the only company responsible for exploration and production (E&P) activities.

Today, however, it is the organizations themselves that will be in charge of carrying them out, and they have great expectations for the following years in regard exploration and production fields in different Mexican coastlines.

Companies are aware of the country's situation, performing in an institutionalized way, pooling into specialized agencies following the highest quality standards for generating long-term sustainable relationships with communities and the environment.

The results of past tenders can be seen from different perspectives, based on the bidding entities and the entities

winning the rounds; however, there is no doubt that the most recent round 1.4, has been a total success in terms of placement of exploration blocks and the joint ventures created between the State and private companies.

Despite this sense of progress, there is still work to be done, since participants in the rounds have been few. For example, there were no tender bids in two blocks, there was only one tender bid in five blocks, and only in one block several tender bids were submitted.

Probably, the limited interest noted so far is due to the contracting terms that the State establishes for corporations interested in participating in the sector.

In addition, it is necessary to consider the current industry conditions, which has not escaped the geopolitical and economic uncertainty, factors limiting companies wishing to participate in tenders, regardless of how attractive the available fields may be.



Power sector: Pending tasks

Greater competition and the use of clean technologies at competitive costs is expected to translate into a reduction of rates in the medium-term.

Half of the electricity generation capacity installed capacity in Mexico is at least 30 years old, which implies limited competitiveness and huge opportunity areas. The Wholesale Electricity Market (MEM, for its acronym in Spanish) was implemented in record time, and opens this sector to the private sector with the aim of promoting competition and optimizing the service.

After the constitutional reforms, the power sector has reaped considerable advances, generated advances and produced concrete results. Tenders have allocated 4,200 new gigawatt-hour, photovoltaic and eolic technologies prices have dropped in contrast with other countries and there are currently over 20 electric energy operators compared with only seven in December 2016. This is result of clear rules that provided certainty to investors.

Moreover, Mexico's renewable energy potential is huge. However, investments are required for encouraging the funding of new projects. The goal is that over the medium term, 5 percent of Mexico's electricity production mix is generated from photovoltaic sources. Still, for achieving further progress, private and public sectors have several challenges to overcome, such as: more investments for new infrastructure to create thousands of new megawatts,

and attracting funds for projects that promote the replacement of the current generation portfolio. Pension and private equity funds as well as energy generators have shown interest in Mexico's electricity scene.

Although the MEM has been explained, its understanding is still out of reach of most Mexicans. It is extremely ambitious to expect a recently-created market to be mature. Encouraging fair competition with the private sector and offering the public even lower rates should remain the core for achieving the success of the wholesale market.

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Self-sufficiency or energy interdependence: What model should be followed?



Finding a balance between security and prosperity in the midst of global uncertainty represents a great challenge for countries and companies on which their future well-being depends.

Energy industry players are optimistic regarding the progress of the reform in Mexico and, above all, the opportunities it represents in the short, medium and long terms. However, a transition process is underway for clearly defining the current needs and how they will be addressed in the future.

There are major challenges such as ensuring the supply of commodities for the industry in different areas, such as petrochemistry, which because of their nature imply large investments and infrastructure projects for ensuring constant supply that allows for competitive costs and an efficient value chain.

Increasingly intense natural phenomena such as hurricanes Harvey and Irma, which struck several countries in the Gulf of Mexico and the Caribbean in 2017, force the industry to rethink

its risk management for building more resilient supply chains that endure extremely adverse circumstances.

Social conditions also play a key role in this issue. Population needs are rising, requiring ever increasing freight and people transportation, which is a turning point that will determine the future of Latin America in terms of energy and economic development in general.

It is an equation whose factors are security and prosperity of the society. Achieving a balance between them in an environment of uncertainty and change is evidently a great challenge. The Energy Reform provides the necessary tools for our country to achieve a viable future in terms of energy, which will favor no doubt all industrial sectors.

Bilateral relationship between Mexico & the United States of America

The topic currently ruling the trade relationship between Mexico and the United States is NAFTA, which is currently undergoing an upgrading process for achieving fairer and more competitive agreements for the parties.

At present, the bilateral relationship between Mexico and the United States has focused mainly in updating the NAFTA. From its enforcement in 1994, the reality of the energy sector in Mexico has gone through several changes that demand reconsideration of the disciplines governing the commercial relationship between the two countries.

NAFTA's success has been evident during the 23 years it has been in force. Each year the benefits of the agreement have been exceeded one trillion dollars, of which 550 billion correspond to the trade between Mexico and the United States.

The operation terms were agreed upon between the three countries comprising this commercial alliance. However, on a worldwide scale, uncertainty and change have become the rule; therefore, such terms are questioned and need to be reframed.

Today, NAFTA is entering a modernization process and we need to get through the message that the agreement has brought along benefits for all three nations. In fact, the North American region has become the most competitive over time because of the integration of several industries, the elimination of tariffs and the generation of more efficient production processes and value chains.

For modernizing the agreement, the Mexican government has established the following principles:

- Reinforcing the competitiveness of the trade region by revising rules of origin;
- Maintain or improve existing mechanisms for the settlement of disputes;
- Encouraging a more inclusive trade that considers the needs of small and medium-sized companies; and
- Adopting and integrating technological platforms

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Mexico, the United States and Canada have the challenge of adjusting to the changing times, reaching agreements to derive in a NAFTA that reviews unfair aspects and adapts best practices for mutual growth.



Conclusions



The success of the Energy Reform is reflected in the major investments in Mexico of new participants, and in the discovery of the oil reserves assigned to private individuals.

Preliminary figures of three billion BBOE, equivalent to 11 percent of Mexico's total reserves, were announced by two private consortiums and are the first major result of the opening up of the energy sector.

In addition, dozens of domestic and foreign-owned gas stations have been opened and will soon be able to import their own gasoline; thus, the competition will enrich the experience and demand of consumers. Also, the opening up of the energy sector has been of great depth and scope: the Federal Electricity Commission has been divided into a dozen of independent regional companies, which will compete with other private generators to supply energy at the best price and in the volumes required by industry and private individuals.

The entire process, from the first biddings of Round One to the processing of permits for the different sector activities, has been transparent, considering the interests of the nation, as well as participant suggestions and experiences. Sound and properly implemented institutions have prevented change from being challenged by acts of corruption.

In a relatively short period of time, the Mexican energy sector should be in a position to regain its growth dynamics by enriching its experience with innovative technologies from international operators, and incorporating disruptive businesses that benefit the country and allow for the consolidation of its economic development.

The worldwide recognized model of change will allow Mexico to consolidate itself as a strongly developed country possessing a modern industry capable of competing in markets in any part of the world.

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