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Oil & Gas Spotlight

Opening Its Borders for Competition

Roadmap to Mexican Energy Reform

In This Issue:

The Bottom Line

- Mexico's energy reform ends 75 years of a state monopoly in the local oil and gas (O&G) and electricity sectors. Under the new program, the Mexican government will enter into arrangements with private investors to exploit unexplored, underused, unconventional O&G reserves and increase competition in the electricity sector to lower local prices.
- Energy reform in Mexico will be implemented in several phases. A two-stage bidding system will be used. In the first stage, bidders will be chosen on the basis of certain criteria, including qualifications, financial strength, work program, and minimum investment commitment. In the second stage, the bidders who have been selected will be considered mainly on the basis of the profitability of the arrangement to the Mexican government.
- The exploration and extraction activities will be made available to contractors under one of four types of arrangements: license contracts, profit-sharing agreements, production-sharing agreements, and service contracts.
- Under U.S. GAAP, an entity is required to disclose certain information about O&G reserves. The overall considerations associated with O&G accounting differ depending on whether the entity applies the full-cost method or the successful-efforts method.
- Under Mexico Financial Reporting Standards (MFRSs), a contractor should develop an accounting policy specifying the types of expenditures that it recognizes as exploration and evaluation assets, expenses, or both. A contractor should apply this policy consistently but would have some flexibility in determining it.
- The activities to date represent the *beginning* of comprehensive energy reform in Mexico. Many elements of the reform are uncertain and numerous regulations still need to be drafted.

Beyond the Bottom Line

This *Oil & Gas Spotlight* provides insight into select aspects of energy reform in Mexico, which could result in more competitive exploration and extraction activities in that country. Topics covered in this publication include (1) the changing regulatory regime in Mexico, (2) the grand plan for implementing energy reform, (3) potential accounting implications of the reform under MFRSs and U.S. GAAP, and (4) the current status of the reform and expectations for the future.

Overview of the Changing Regulatory Regime

Background

The Mexican government has historically controlled the country's energy sector. Since 1938, Petróleos Mexicanos (PEMEX) has been the sole entity responsible for the exploration, exploitation, refining, transportation, storage, distribution, and sale of various hydrocarbons in Mexico. As a result of this state-sponsored monopoly, competition was limited and economic growth and productivity slowed significantly. Oil and gas revenue generated by PEMEX plays a crucial role in Mexico's national budget, which has been directly affected by the decline in oil and gas production as well as unsuccessful investments by PEMEX over the years. To improve this situation and to supplement PEMEX's technical expertise in deep-water and unconventional plays, Mexican President Peña Nieto recently introduced an energy reform program designed to spark growth in the country's economy and the related energy infrastructure.

Activity to Date

The December 2013 amendments to the Mexican constitution, along with the enactment of further legislation, have effectively opened the Mexican O&G energy market to private and local investors for the first time since PEMEX was established. Mexico's new energy reform ends 75 years of a state monopoly in the local O&G and electricity sectors. The objectives of the reform are to build the Mexican energy industry by attracting private capital and technical expertise, maximize O&G revenue, and boost economic growth through 2025.

Mexico's new energy reform ends 75 years of a state monopoly in the local O&G and electricity sectors.

Under the new program, the Mexican government will enter into arrangements with foreign investors to exploit underused, unconventional O&G reserves and increase competition in the electricity sector to lower local prices. While subsoil hydrocarbons will remain property of the Mexican government, private entities (referred to as contractors) will be permitted to participate in *exploration and extraction* activities (as defined by the Mexican government) in varying degrees by entering into one of four different types of arrangements (discussed in greater detail below).

Grand Plan for Implementing Energy Reform

Energy reform in Mexico is being implemented in several phases. In the first phase (i.e., "round zero"), the Mexican government awarded to PEMEX 83 percent of the country's probable reserves and 21 percent of its prospective resources (mainly conventional fields, but also deep water and unconventional fields).[1]

Round one is currently underway and represents the first bidding among interested contractors. The first bid, which includes 14 exploration blocks in shallow waters under a production-sharing agreement, was made in December 2014; 19 companies and 7 consortiums have been prequalified, and economic proposals have been submitted and will be made public in July 2015. Participants include international integrated O&G companies, independents, and Mexican O&G companies. Two more bids have been announced officially, one for exploration activities in shallow waters under a production-sharing agreement, the other for onshore exploration activities under a license agreement. The Ministry of Energy also announced that a fourth set of bids for round one will be made public shortly, including exploration activities in deep waters, areas with extra heavy oil, and PEMEX farmouts.

[1] The December 2013 constitutional amendment allows PEMEX to retain all fields that were producing as of December 20, 2013.

A two-stage bidding system is used. In the first stage, bidders are chosen on the basis of certain criteria, including qualifications, financial strength, work program, and minimum investment commitment. In the second stage, the bidders who have been selected are considered mainly on the basis of the profitability of the arrangement to the Mexican government.

Exploration and extraction activities are made available to contractors under one of four types of arrangements: license contracts, profit-sharing agreements, production-sharing agreements, and service contracts. (For more information about the types of contracts, see the appendix.)

License Contracts

Under a license contract, a contractor would be provided with a specific production area in which it can uplift, market, and sell the hydrocarbons extracted from the ground. In exchange for the license, the contractor would be required to remit certain payments to the Mexican government in the form of various fees, including, but not limited to, bonuses paid to participate in the bidding process, an exploratory phase fee,[2] and royalties based on a percentage of net production.

Profit-Sharing Agreements

In a profit-sharing agreement, all production for the given property would be marketed and sold by the Mexican government; the resulting proceeds would be deposited into the state-managed Mexican Petroleum Fund. As payment for its efforts, the contractor would receive its share of the profits as well as cost reimbursements from the fund. In this type of arrangement, the title of the production property would not be transferred to the contractor. As with a license contract, the contractor in a profit-sharing arrangement would be subject to certain other fees, including the exploratory phase fee and royalties.

Production-Sharing Agreements

Under a production-sharing agreement, the contractor would extract all of the O&G, remitting a certain percentage of extracted hydrocarbon volumes to the Mexican government. The contractor would be paid its share of the profits in kind rather than in cash and would also be reimbursed for costs incurred in kind (i.e., the contractor would retain and market its share of the hydrocarbons extracted). The title of the property would be transferred to the contractor in a production-sharing agreement. In addition to remitting a percentage of the production to the Mexican government, contractors would be subject to certain other fees, including the exploratory phase fee and royalties.

Service Contracts

Service contracts differ significantly from the other three arrangements. Rather than having a working interest in the property through which they would receive payment in the form of cash or an in-kind commodity, entities that enter into service contracts would transfer all O&G production to the Mexican government in exchange for cash payments from the Mexican Petroleum Fund. In this type of arrangement, the contractor would truly be serving as a service provider and would have no interest in the underlying hydrocarbons.

Accounting Implications Under U.S. GAAP and MFRSs

License Contracts, Profit-Sharing Agreements, and Production-Sharing Agreements

Contractors will first have to determine whether a contract is within the scope of existing U.S. GAAP or MFRSs. In particular, entities will need to determine whether the contract meets the definition of a joint arrangement and, if so, how it should be accounted for under the applicable U.S. GAAP or MFRSs. Other applicable U.S. GAAP or MFRSs should also be analyzed, such as standards addressing whether (1) a contract conveys the right to use assets in return for a series of payments or (2) a license could represent a concession arrangement for the supply of public services. However, it seems unlikely that a contract will be within the scope of such standards.

Under U.S. GAAP, an entity would need to disclose in its accounting policies the applicable standards it considered when determining the accounting for these types of transactions. In contrast, under MFRSs, explicit accounting guidance might not exist, in which case an entity would need to use judgment to develop an accounting policy on the basis of the substance of the transaction. Further, under MFRSs, a

2 The exploratory phase fee serves as an incentive to the contractor to expedite exploration of the area.

contractor should develop an accounting policy specifying the types of expenditures that it recognizes as exploration and evaluation assets, expenses, or both. A contractor should apply this policy consistently but would have some flexibility in determining it. Conversely, from a U.S. GAAP perspective, the determination of what qualifies as an eligible capitalizable expenditure should be based on an assessment of how closely associated the expenditure is with finding specific mineral resources. In practice, an entity applies the *successful-efforts* or *full-cost* method of accounting in making this determination.

In license contracts, the contractor will generally recognize the proceeds from the sale of the hydrocarbons as revenue. In production- or profit-sharing arrangements, proceeds from the sale of oil for recovery of the contractor's costs, expenses, and investments (i.e., "cost oil") are likely to be recorded as oil revenue; once costs are recovered, "profit oil" would be recognized as revenue for the contractor's share of production.

O&G reserves are not recorded as an asset in the statement of financial position, with some exceptions (e.g., when the reserves are acquired in a business combination, in which case they are used to determine the value of the acquired O&G properties). Under U.S. GAAP, an entity is required to disclose certain information about O&G reserves, including proved O&G reserves, standardized measures of discounted future cash flows, and changes in standardized discounted cash flows. In addition, certain other information is required by Regulation S-K, Subpart 1200,[3] and Regulation S-K, Item 302.[4]

In contrast, MFRSs do not specifically require disclosures about reserves. However, an entity applying MFRSs will generally provide disclosures about reserves in the footnotes to the financial statements to comply with fair presentation principles, under which an entity must provide disclosures in addition to those required by standards. Because of the lack of guidance on this topic under MFRSs, entities have often applied U.S. GAAP to disclosures about O&G reserves. Reserves might have other effects on financial information as well. For instance, capitalized costs of O&G properties with proved reserves are commonly amortized by using the units-of-production method, with proved reserves as a basis for the calculation.

It is likely that under most of the types of contracts, contractors would bear the exploration risk and would disclose, in their financial statements, their share of the reserves even though the reserves are the property of the Mexican state. The proposed laws do not include legal restrictions on the disclosure of such reserves (certain other countries' laws do contain such restrictions), which promotes investment and financial statement transparency.

Service Contracts

In a contract in which the contractor does not bear exploration risk, it will not be deemed to be performing exploration and evaluation of mineral resources from an accounting perspective. Under such contracts, when the outcome of a transaction involving the rendering of services can be estimated reliably, the contractor would recognize revenue by reference to the stage of completion. Generally, it will not disclose the reserves in its financial statements. If service contractors assume exploration risk, they may be able to use accounting methods similar to those described above for profit- and production-sharing agreements.

Thinking Ahead

The activities to date represent the *beginning* of comprehensive energy reform in Mexico. Many elements of the reform are uncertain and numerous regulations still need to be drafted. What is certain, however, is that the long-lasting monopoly on O&G exploration and extraction activities that has existed in Mexico for decades is being overhauled and replaced with a more competitive system. It is hoped that system will rejuvenate economic activity associated with the energy sector in Mexico and modernize the related infrastructure.

Deloitte has an experienced team of professionals, both in the United States and globally throughout the member firms of Deloitte Touche Tohmatsu Limited, who can help entities understand the implications of the Mexican energy reform. In response to such developments, Deloitte's O&G industry team will (1) host live industry seminars, (2) conduct quarterly accounting update webcasts, and (3) publish industry Spotlights as warranted. In addition, see Deloitte's January 2015 *Oil & Gas — Accounting, Financial Reporting, and Tax Update* for more information about other activities in the O&G sector.

[3] SEC Regulation S-K, Subpart 1200, "Disclosure by Registrants Engaged in Oil and Gas Producing Activities."

[4] SEC Regulation S-K, Item 302, "Supplementary Financial Information."

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Appendix — Types of Contracts

The table below highlights certain key implications of each type of contract for contractors and the Mexico government.

	Licenses	Profit Sharing	Production Sharing	Service Contracts
Remuneration of contractor	Sales price of hydrocarbons once extracted from the subsoil.	In cash: • Recovery of costs. • Operational profit after remuneration of government.	In kind: • Recovery of costs. • Operational profit after remuneration of government.	In cash for production delivered. Payments are made by the Mexican Petroleum Fund.
Marketing of hydrocarbons	Contractor markets the hydrocarbons.	Contractor delivers all the hydrocarbons to the state's designated marketing entity.	Contractor markets its share of the hydrocarbons. The contract will be used to determine remunerations to be paid in kind to the marketing entity.	N/A
Remuneration of government	See below	See below	See below	All contractual production
• *Signing bonus* — The amount is defined before the bidding process and will be paid in cash by the contractor. The amount is not expected to be significant and is meant to promote the formality of the bids.	√	√	√	N/A
• *Exploratory phase fee* — Serves as an incentive to the contractor to expedite exploration of the area. Amounts to MXP$1,150 during the first 60 months and to MXP$2,750, thereafter, per square kilometer.	√	√	√	N/A
• *Royalties* — Payment equivalent to a percentage of the net value of the production. Rates are determined as follows: ◦ Oil: [(0.125 × contractual oil price) + 1.5]%, with a 7.5% floor. ◦ Natural gas: determined as a function of the contractual natural gas price and by considering price ranges for non-associated natural gas.	√	√	√	N/A
• *Additional compensation*	√ Percentage of the net value of the production.	√ Percentage of the net value of the production.	√ Percentage of the net value of the production.	N/A
Determination of operating profit	N/A	Contractual value of hydrocarbons (the mechanisms for determining this are included in each contract and are meant to be by reference to market prices). The value would be adjusted by (1) royalties and (2) compensation of recovery costs. Note that recovery costs are capped with carryforwards of excess amounts. Nondeductible items are noted.		N/A
Income taxes • *Specific depreciation rates for contractors are provided.*	• 100 percent of investments for exploration, secondary and improved recovery, and noncapitalizable maintenance. • 25 percent of investments for the development and exploitation of oil and natural gas wells. • 10 percent of investments for transportation and warehousing infrastructure that is critical for the execution of the contract.			

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