The Contractual Regime in the Oil & Gas Sector in Mexico

Energy and Natural Resources Group
Tax and Legal
The Mexican Senate approved, on Tuesday August 5th, the Hydrocarbons Revenue Law and the Mexican Petroleum Fund Law, as well as the amendments to the Federal Rights Law and Fiscal Coordination Law.

The new Hydrocarbons Revenue Law contains, among other points, the mechanisms to determine the amount of the rights and considerations to be paid to the Mexican State by PEMEX and other participants derived from the assignments or contract to explore and extract oil, gas and condensate.

On this document we outline the topics we consider of relevance, and highlight a few aspects that differ from proposals previously discussed in Congress.

**Contracts and Assignments**

The different types of contracts and assignments for the exploration and extraction of hydrocarbons, as well as the considerations arising therefrom, include the following:

1. **License contracts**

License contracts provide for the following payments and considerations:

   A. At the expense of the new participant and for the benefit of the Mexican State:
      a) A signing bonus;
      b) Payments during the exploratory phase;
      c) Royalties, and
      d) A consideration to be determined by applying a rate to the contractual value of hydrocarbons

   B. For the benefit of the contractor, the onerous transmission of hydrocarbons extracted from below ground, and provided that, under the terms of the contract, the contractor is current in meeting the obligations specified in paragraph A above.

2. **Profit sharing contracts**

The profit sharing contracts provide for the following payments and considerations:

   A. At the expense of the new participant and for the benefit of the Mexican State:
      a) Payments during the exploratory phase;
      b) Royalties, and
      c) A consideration to be determined by applying a rate to the operating profit generated by the contractor.
B. For the benefit of the contractor:
   a) The recovery of costs, subject to the provisions of
      the law itself, and
   b) A consideration which shall be the remnant of the
      operating profit after covering the payments to
      the Mexican State mentioned in section A point
      c) above.

In the case of shared profit contracts, the contractor will deliver
the entire contracted production to the distributor which in
turn will deliver the revenue from such commercialization to
the newly created Mexican Petroleum Fund.

3. Production sharing contracts

Production sharing contracts provide for the following
payments or considerations:

A. At the expense of the new participant and for the
   benefit of the Mexican State:
   a) Payments on exploratory phase;
   b) Royalties, and
   c) A consideration to be determined by applying a
      rate to the contractual value of hydrocarbons or the
      operating profit generated by the contractor.

B. For benefit of the contractor:
   a) The recovery of costs, subject to the provisions
      contained in the law itself, and
   b) A consideration which shall be the remaining
      operating profit after covering the consideration to the
      State mentioned in section A point c) above.

However, such value is to be paid in kind with the hydrocarbons
themselves, with a percentage of the contractual production
equivalent to the referred value.

In accordance to the nature of the production sharing contracts,
the consideration set forth in the preceding section shall be
paid in kind, with a ratio of hydrocarbon production that is
equivalent to the value of such charges.

4. Service contracts

It is established that in service contracts for the exploration
and extraction of hydrocarbons, contractors shall deliver to
the Mexican State the entire production and the contractor’s
payment (as established in each contract based on industry
standards) shall always be paid in cash.

Such consideration to be paid to the contractor will be made
by the Mexican Petroleum Fund from the proceeds generated by
the sale of the contractual production resulting from each
service contract.

5. Assignment

PEMEX or any other productive state-owned enterprise that
holds an assignment (administrative legal act by which the
Federal Executive Branch grants to the assignee the right to
carry out the exploration and extraction of hydrocarbons),
shall pay a fee on shared profits by applying a rate of 65%
to the difference resulting from reducing the value of the
hydrocarbons extracted during the fiscal year in question
(including the consumption of these products) by the
allowable deductions.

New state Tax on the Exploration and Extraction
of Hydrocarbons

In addition to the payments received by the Mexican State
from contractors and assignees, they will be required to pay
an additional tax due for the exploration and extraction of
oil, applying the procedure mentioned at the end of this
document.

Equalization of PEMEX’s tax regime with other
participants in the industry

PEMEX is currently subject to special fees and is not considered
a taxpayer for income tax purposes. As a result of (i) the
transformation of PEMEX into a productive state company
and (ii) the possibility of involvement of other companies in
the exploration and production of hydrocarbons in Mexico, it
is recognized by the Lower House that there is a need for an
equal tax treatment between the private participants and
PEMEX.
Specifically, this implies replacing the PEMEX’s existing tax regime with the following fees:

a) Rights on hydrocarbon exploration at the rate of MXN 1,150 per sq km for the first 60 months and MXN 2,750 per sq km in the following months. (These are amounts equivalent to those to be paid by contractors).

b) Rights for the hydrocarbon extraction at varying rates by product type (crude oil, natural gas-associated and not associated- and condensate) over the price of oil.

c) Rights for the Shared Profit at a 65% rate, with a more flexible cap on its deductions.

An improved mechanism for associations is created

The Hydrocarbon Revenue Law also establishes that both productive state-owned enterprises and Mexican corporations may participate in the bidding either individually or in joint ventures, as well as in a consortium. The latter option was introduced recently.

The incorporation of a consortium figure is a significant improvement as it allows for the existence of joint operating agreements, a common mechanism to reduce the risks and costs in capital-intensive industries, such as the oil industry.

Holding various contracts is now allowed

The Law allows PEMEX and private companies to receive and maintain more than one contract. This feature allows both to take advantage of economies of scale and to diversify risks associated with exploration activities.

Increased availability of NOL

In alignment with the typical life span of a deep-sea well, there is a possibility to extend up to 15 years (currently allowance is 10 years) the period during which tax losses determined in terms of the Income Tax Law can be decreased from a taxable profit.

The foregoing is without prejudice to previously established rules which allowed for the depreciation of assets at the rates of 100%, 25% and 10% for investments in exploration, development and infrastructure, respectively, applicable to determine the base of the rights for Shared Profit by PEMEX referred to above.

Bid contracts would be awarded based on various factors such as minimum investment and maximization of the considerations

In accordance with the constitutional provisions on energy matters, the principle of maximizing the state revenue with such contracts is incorporated in the bidding processes. However recent changes include the addition of variables to ensure the extraction of hydrocarbons in a sustainable way in the long run; these variables include the amount of guaranteed investment and minimum acceptable bid values.

A 0% VAT rate is applied on considerations to improve cash flow

In terms of the current tax law, the considerations shall be subject to Value Added Tax. In order to improve the cash flow of participants, a VAT rate of 0% is suggested (i.e. on the considerations for license, profit sharing, production sharing and services contracts) to the extent that the payment is made to the Mexican Petroleum Fund.

Improvement to the legal framework

Clarifications were made on various definitions such as commercialization, professional, period, cost recovery limit and measurement point, among others.

The new legislation also incorporates provisions to guarantee that the investment recovery factor will be established from the beginning of the bidding process. This investment recovery factor cannot be changed during the process.

Increased disclosure of expected economic terms

The legislative process also incorporates an article to include the obligation of the Ministry of Finance to publish, within the first 15 days of the year, a range of values that may be used (given that certain conditions exist and that such conditions do not change) to set the terms in the tenders. This will generate more information prior to bidding procedures.
The considerations for the benefit of the licensee may become payable before considerations are due to the State

In the legislative process, a statutory provision was amended to allow payments to the licensee when contractual conditions are met and not necessarily after the consideration from the production is paid, i.e. the contractor is considered to be a creditor, provided it is in compliance with its contractual obligations.

New tax imposed on the exploration and extraction of hydrocarbons without increasing the tax cost

A new tax is additionally created in order to provide financial support for states and municipalities (through a Fund specifically created to that effect) where oil activities are carried out in order to mitigate the negative externalities to the environment and to foster investment in infrastructure.

The new tax is dependent on the phase of the project and it is computed considering a rate of MXN 1,500 per sq. km during the exploration phase and MXN 6,000 per sq. km during the extraction phase. Resources from this tax will be delivered to the states and a portion will be allocated to municipalities.

Entry into force

1. The new Hydrocarbons Revenue Law and the Mexican Petroleum Fund Law will enter into effect the following day to their publication in the Official Gazette, except the provisions included in the assignments chapter (rights to be paid by productive state-owned enterprises), which will come into effect on January 1, 2015.

2. During 2014, PEMEX and its subsidiaries shall pay rights under the current Federal Rights Law for the activities carried out under their assignments. As of January 1, 2015, they will have to pay their respective rights under the new Hydrocarbons Revenue Law.

3. For purpose of the shared profits rights that PEMEX and its subsidiaries are required to pay, instead of applying the rate of 65%, during fiscal years 2015 to 2018 the rates of 70.0%, 68.75%, 67.50% and 66.25% shall apply, respectively.
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