Following the constitutional amendments of December 2013 and the so-called secondary legislation (including the oil tax regime included in the Law on Hydrocarbons Revenue) issued in August 2014, on December 11, 2014 the Mexican government released the bidding rules for the production sharing contracts for exploration and extraction of hydrocarbons in shallow waters, called Round 1, through the webpage http://www.rondauno.gob.mx.

The documents include the model "contract for exploration and extraction of hydrocarbons under production sharing modality" (the Model Contract), both the individual and consortium formats, which would be signed between the National Hydrocarbons Commission and contractors (and other participants if engaged under a consortia). It shall be noted that in accordance with the bidding rules, there may be changes to this proposed contract.

The Model Contract is a milestone in the implementation of the energy reform as a clear contractual arrangement with flexible and arm’s length tax rules which will largely outline the success of the implementation of the Mexican energy reform. Indeed, the model contract includes provisions governing the determination of the considerations for participants, which is a key issue.

This document incorporates the provisions that we consider relevant; it may be necessary to refer to Annex 3 and 4 of the Model Contract, the Law on Hydrocarbon Revenues (LIH) and the Hydrocarbons Law as well as the Income tax Law, to completely understand each concept.

Overview of the Model Contract

The model contract (in the individual and consortium versions) for the exploration and extraction of hydrocarbons in the form of production sharing within the first call for Round One (shallow waters) includes 34 clauses (with their respective sub-clauses) and 11 annexes. From a tax perspective key sections include clause 16 (titled “Consideration”), Annex 3: Procedures for Determining the Consideration of the State and the Contractor, Annex 4: Accounting Procedures, Registration and Recovery Costs, Expenses and Investment, and Annex 11: Procedure for Release of Information and Payment of consideration to the Mexican Petroleum Fund for Stabilization and Development.

Relevant topics

Nature of contract: The contract to execute oil and gas activity in the production sharing modality implies that the contractor is responsible and will cover costs and provide personnel, technology, materials and financing for the development of the contract area. No real rights on contractual areas or on subsoil resources are granted (the resources remain the property of the Mexican State); however, the contractor is able to report for accounting purposes the expected financial benefits of the contract.

Characteristics of participants: The Model Contract addresses the characteristics required by the Constitution and so-called Secondary Laws on energy, requiring that the contractor (and participating companies in the case of a consortia) must be corporations, incorporated and with legal personality under Mexican Law, with a tax residence and Tax Identification Number in México, eliminating the possibility of concluding contracts with Joint Ventures, or companies incorporated under non-Mexican law, either with nor without a permanent establishment in Mexico.

In addition, these companies shall be exclusively engaged on the exploration and extraction of hydrocarbons and shall not be taxed under the optional tax regime for groups of companies referred to in Chapter VI of Title II of the Income Tax Law, eliminating the possibility of combining for tax purposes income and deductions from other activities, either in the same entity (due to the limitation of the business purpose) or with other entities (due to the limitation of the group consolidation regime).

Extent and Phases: The contract may be renounced by the contractor or, after completion of deadlines in each phase (without compensation or dismissal of their obligations, and returning the contractual areas to the government); the contract will last twenty-five years and may be renewed up to two times. Said contract has clear phases and minimum work programs for each phase.

Governing Law and Dispute Resolution: The Model Contract is governed by the laws of Mexico (disputes shall be resolved by Mexican courts and arbitration will conform to the Rules of the United Nations Commission on International Trade Law. Contractor is requested to disallow diplomatic claims).
Key rights and obligations

Property of Mexico: The construction, installation, repair and overhaul of wells, as well as installations required for the production and collection of hydrocarbons is the sole responsibility of the contractor. The technical information and samples derived from studies are property of the state, and may be used by the contractor for its oil and gas activities, with the sole restriction being for commercialization.

The materials used in the oil and gas activities shall be transferred to the state, without charge, upon termination for any reason of the Contract, it being understood that the Contractor shall perform the transfer of materials in good condition and operation, taking into account normal wear from use. Excluded from the transfer under this rule are leased materials or those owned by third party subcontractors, as long as the lessors and subcontractors are not related parties to the contractor or participating enterprises.

The leases entered into by the contractor to carry out its activities (leasing of collection facilities is prohibited) shall indicate that in the case of early rescission, the CNH will have the option to request the assignment of leases in favor of a third party under the same conditions.

Assignment of Contract Rights and indirect transfer of control: Any transfer of rights or obligations of the Contract, and the imposition of limitations on the rights of the contract, requires prior written approval of the CNH. The transfer of rights and obligations is subject to the prequalification criteria and certain rules of joint liability.

The Contractor and each Participating Company states that it shall not suffer, either directly or indirectly, a change of control during the term of the Contract without the prior consent of CNH.

Also, any change in the equity structure of the Contractor or Participating Companies must be informed within 30 days following the operation, unless the company is listed on the Mexican Stock Exchange.

Performance guarantees, abandonment plan and abandonment trust: The contract states that a letter of corporate guarantee shall be requested of the contractor as well as an unconditional and irrevocable letter of credit in favor of the Mexican Petroleum Fund by an authorized financial institution in an amount determined in the contract, to ensure adherence to work programs. The contractor shall also be required to comply with obligations regarding abandonment of wells, creating a trust for compliance and implementation of a plan of orderly termination.

Insurance: The contractor shall obtain and maintain insurance policies in accordance with industry best practices and those required by the Agency (and the entities authorized by the agency). The responsibilities of the contractor persist in the existence or absence of insurance.

Accounting and documentation: The contractor shall maintain, and make available to audit, all accounting records, supporting documents and related documentation regarding the oil and gas activities in accordance with the accounting procedures for a period of five years after termination of the contract and authorize other suppliers to deliver information related to this contract to the authorities as required.

Measurement: Measurement of volume and quality of hydrocarbons may be conducted at wellhead, separation plants or over the length of the collection and storage systems; however, the contractor shall propose the measurement point for delivery, in accordance with international standards and according to acceptable deviations. In case of an error, adaptation mechanisms exist.

Procurement, supply and local content

Procurement and supply of services: In order to comply with the principles of transparency, economy and efficiency, the contractor must adhere to certain procedures for procurement of services and purchase of goods, ranging from preserving supporting documentation demonstrating that transactions were carried out at fair market value, to international public tenders, depending on the value of the contract.

Subcontracting: Subcontracting involving de facto replacement of the contractor as an operator or with disabled companies is not permitted.

National Content: local content is set to meet a minimum percentage of domestic content in stages (13% in the period of exploration, 25% in the first year of development and 35% by 2025) in accordance with the Methodology established.
In case of default, the contractor shall pay a penalty to the state consisting in a percentage of the value of the concepts outlined in the methodology established by the Ministry of Economy for measuring local content which have been acquired in breach of the minimum percentages of required local content ranging from 15% for the period of exploration through 20% in the first year, 40% in the second, 60% in the third, 90% in the fourth and 100% in the fifth year of the development period.

There is an obligation to prefer procurement of Mexican origin (including for recruiting at a technical and management level, Mexican nationals) where there are equal conditions and availability.

**Taxation of hydrocarbons**

The LIH establishes the consideration to which contractors and the State are entitled arising from participation in the activities of exploration and extraction of hydrocarbons.

Thus, the model contract is consistent with the law by noting that on a monthly basis, the Mexican Petroleum Fund will compute and pay the considerations to the State and the Contractor or Participating Companies; this will occur when regular commercial production starts and delivery of hydrocarbons exists at the measurement points. Considerations will be paid based on the information received from the Contractor and the computation performed by the CHN according to Annexes 3, 4 and 11 of the Model Contract.

Payments will be made within seven working days of receipt of the information from the CNH. CNH will deliver the information within the first 10 working days of the following month to which the original data corresponds.

Thus, the State will receive: (a) the contractual fee applicable for the exploratory phase; (b) royalties, and (c) a percentage of operating income, which may be adjusted in accordance with a mechanism established in Annex 4 of the Model Contract, in addition to the Income Tax derived from the activities.

**Consideration as a percentage of operating income:**

Operating income is calculated by subtracting from the revenues of the project (contractual value of hydrocarbons) with recognized recoverable costs, considering a cost limit per period, and subtracting royalties. Annex 3 of the Contract shall indicate (after obtaining the percentage offered by the winning bidder) explicitly the percentage for the State of operating income for each period. The remainder of this profit corresponds to the contractor.

The contractual value of hydrocarbons in each period is the sum of the production value, i.e. multiplying the contractual price of each type of hydrocarbon (oil, natural gas or condensed hydrocarbon) by the volumes produced in the contractual area, determined at the point of measurement of each product.

Annex 3 establishes the mechanism for determining contractual prices (where they may differ from those reported by the contractor or marketer, generating future compensation on predetermined considerations). It is noted that dispute settlement mechanisms exist to adjust prices to market rules (such as cost of storage, transport or treatment, and where appropriate, consistent with transfer pricing rules).

The recoverable costs are those listed in Annex 4 (provided they comply with the guidelines issued by the Ministry of Finance, in effect on the effective date and comply with the accounting procedures established therein), amount which shall be limited in each period to a percentage (in this case the Annex indicates 60%) of the contract value of the hydrocarbons produced in a given month. Unrecovered costs will be transferred to subsequent months without indexation, and will exist as long as the contract exists.

It should be noted that the consideration as a percentage of operating income will be subject to modification according to the following adjustment mechanism:

**Adjustment Mechanism:** This mechanism regulates the compensation as a percentage of operating income based on the performance of the contractor (pre-tax operating income).

This metric is based on the accumulated operating results of the contractor such that (i) when the metric of operating income before taxes for the immediately preceding period is less than 15%, the percentage the contractor receives will be 100% of the agreed consideration; (ii) where the metric of operating income before taxes for the immediately preceding period is less than 30% but more than 15%, an adjustment mechanism that regulates this profit shall be a gradually decreasing percentage to a minimum profit and (iii) when performance metrics of operating profit before tax for the immediately preceding period exceeds 30%, the percentage of operating income which the contractor will receive is the minimum percentage of operating income received at the beginning of contract (equivalent to the percentage at the beginning of contract by a factor of .20).

**Contractual fee in the exploratory phase:** The fee for the exploratory phase consists of a payment for the contracted area as there is no production quantity. The amount for the first 60 months of the Contract shall be $1,150 pesos per square
kilometer and from month 61 of the Contract and thereafter in the amount of $2,750 pesos per square kilometer. In accordance with Annex 4 of the Contract Model these amounts shall be updated from the second half of January of each year according to the Mexican Consumer Price Index.

Royalties: The royalty shall be a payment based on gross income and is an increasing rate based on the price of hydrocarbons. In view of the provisions of the LIH, royalties are determined for oil, associated natural gas, non-associated natural gas or condensates, applying the rate to the contractual value of hydrocarbons produced in a given month. Annex 3 details the mechanisms which from January 2016, the rates will be indexed in accordance with the Consumer Price Index of the United States of America.

Rights and Exploitation: Additionally, the Contractor shall be required to pay in a timely manner the rights and duties established by the Applicable Regulations for the administration and audit of this contract, performed by the CNH and the safety agency.

Consortium model

The consortium version of the Model Contract considers participation in a group format with several participants, so the terms and definitions of the individual contract are adapted to the special circumstances of a consortium; the most important adjustments are as follows:

In the definitions, the contractor concept is extended to consider as such the participating companies jointly (and not only one contractor), thus all participating companies are party to the Model Contract. Also, the concept of corporate guarantor is extended to include each of the participating companies.

Similarly the consideration of the contractor shall be allocated to the participating companies in accordance with their Participation Interest (defined as “the undivided portion of each of the participating companies, expressed as a percentage of the total shares of all participating companies”) in the rights of each participant under this contract, it being understood that each participating company shall be jointly liable for all obligations of the contractor under this contract regardless of participation interest.

This implies that although the contract includes an operator (title which may be revoked or removed subject to compliance with prequalification requirements) responsible for operational aspects of the oil and gas activities (Participating Enterprise designated and empowered by the others, which should
comply with the obligations of the contractor in name and representation of the indicated entities), this does not relieve joint liability and makes binding for each participant any agreement made by the operator.

A key clause establishes that the Companies may sell directly that part of production which corresponds to each entity, and not necessarily through the operator.
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