14 August 2014

Global Tax Alert

News from Americas Tax Center

New Mexican fiscal system approved for the oil and gas industry

On 11 August 2014, Mexico's President Enrique Pena Nieto signed the package of laws that constitute the secondary legislation related to the landmark energy reform (the Energy Reform), which significantly affects the oil and gas industry. The package includes certain rules related to tax and other fees to be paid to the Government, along with additional regulatory guidance.

This Alert addresses the main changes regarding the tax issues and fiscal terms that will affect the exploration and production of oil and gas in Mexico. Specifically, it focuses on the Revenue of Hydrocarbons Law (Revenue Law) and the Hydrocarbons Law enacted as part of the Energy Reform.

General overview of the energy reform

In December 2013, the Mexican Constitution was amended to loosen the restrictions on the energy industry. These constitutional amendments represented a game changer for Mexico's state-owned hydrocarbon resources, as the basis to expand the types and nature of hydrocarbon investment contract models with private investors. In addition, the reform loosened control of other aspects of the energy industry, including a full liberalization of the midstream and downstream activities within the oil and gas industry, as well as an open market for the generation of power.

The constitutional amendments required the implementation of secondary legislation, for which a proposal of secondary legislation was submitted by the President on 30 April 2014 (the Original Bill) for its discussion in Congress. After several weeks of debates and several amendments made by the legislature, the secondary laws were finally approved.

The secondary legislation provides the legal framework for the opening up of the oil and gas industry. In general terms, the secondary legislation relies on the principle that unextracted hydrocarbons remain the property of the Mexican State. However, the adopted legislation provides the roadmap for a free and open competition between state-owned companies (i.e., Petroleos Mexicanos, Pemex) and private companies, for the exploration and production of oil and gas.

EY Americas Tax Center

The EY Americas Tax Center brings together the experience and perspectives of over 10,000 tax professionals across the region to help clients address administrative, legislative and regulatory opportunities and challenges in the 33 countries that comprise the Americas region of the global EY organization.

- Copy into your web browser:

http://www.ey.com/US/en/Services/Tax/Americas-Tax-Center---borderless-client-service

The secondary legislation signed by the President includes modifications to 12 existing laws and the creation of nine new statutes:

- Hydrocarbons Law (*Ley de Hidrocarburos*). Establishes the overall framework by which the exploitation of hydrocarbons will be performed. It provides rules for the types of contracts that will be granted for exploration and production to the industry operators, as well as the rules through which such contracts will be granted.
- Revenue of Hydrocabrons Law (*Ley de Ingresos sobre Hidrocarburos*). Regulates the distribution of oil and gas revenues between the Government, the state productive entities and the private contractors, as well as the taxation that will apply to the new contracts entered into with private investors and the state productive entities.
- PEMEX Law (*Ley de Petróleos Mexicanos).* Reorganizes PEMEX's activities, and seeks to transform PEMEX into a productive State company. It provides regulations for corporate governance, as well as audit and assurance, among other changes to PEMEX's current structure.
- CFE Law (*Ley de la Comisión Federal de Electricidad*). Establishes the organization, functions and operation of the CFE, as well as provides new rules for entering into procurement contracts for leasing, services and public works.
- Electricity Industry Law (*Ley de la Industria Eléctrica*). Oversees the regulation of the generation, transmission, distribution, and commercialization of power and electricity, as well as sets requirements for industry members on issues such as clean energy, open access, supply, among others.
- Petroleum Fund Law (*Ley del Fondo Mexicano del Petróleo para la Estabilización y el Desarrollo*). Establishes and regulates a State-owned fund that will receive, invest and manage all the non-tax revenue derived from the new contracts and assignments.
- Agency of Industrial Safety and Environmental Protection for the Oil Industry Law (*Ley de la Agencia Nacional de Seguridad Industrial y de Protección al Medio Ambiente del Sector Hidrocarburos*). Creates a decentralized agency that will regulate and monitor the industrial, operational and environmental protection, related to the locations and activities of the hydrocarbons sector.
- Geothermal Energy Law (*Ley de Energía Geotérmica*). Regulates the exploitation of geothermal resources located in the subsoil, which includes the participation of private investors through the granting of permissions and concessions.
- Coordinated Regulatory Agencies Law (*Ley de Órganos Reguladores Coordinados en materia energética).* Creates two regulatory agencies: the National Hydrocarbons Commission, for exploration and production (upstream) activities; and the Energy Regulatory Commission, for transportation, storage, distribution and retail of oil, gas and electricity (downstream) activities.

Government take

The total revenue, a percentage of the value of the oil and gas produced, received by a government is commonly referred to as the "government take." The approved Revenue Law establishes different types of "compensation" (*contraprestacion*) that will be considered the government take and will be paid depending on the type of contract. These payments are independent from the corporate income tax and dividend withholding tax that should be paid by the operators and their shareholders.

Consistent with the Original Bill submitted by President Peña, the Revenue Law refers to three different types of contracts that can be entered into with private contractors and state productive entities, such as PEMEX: (i) license agreements; (ii) profit sharing and production sharing agreements; and (iii) services agreements.

The services agreements will continue to operate in a manner under which the Government will compensate the contractor with a fee paid in cash. For all other agreements, depending on the specific type of contracts, the following payments might be made to the Government by the contractor: (a) upfront signing bonus; (b) contractual quota for exploration period (CQEP); (c) a revenue-based royalty; and (d) a profit sharing payment based on the net operating profit or value of hydrocarbons.

Common types of compensation

Royalties

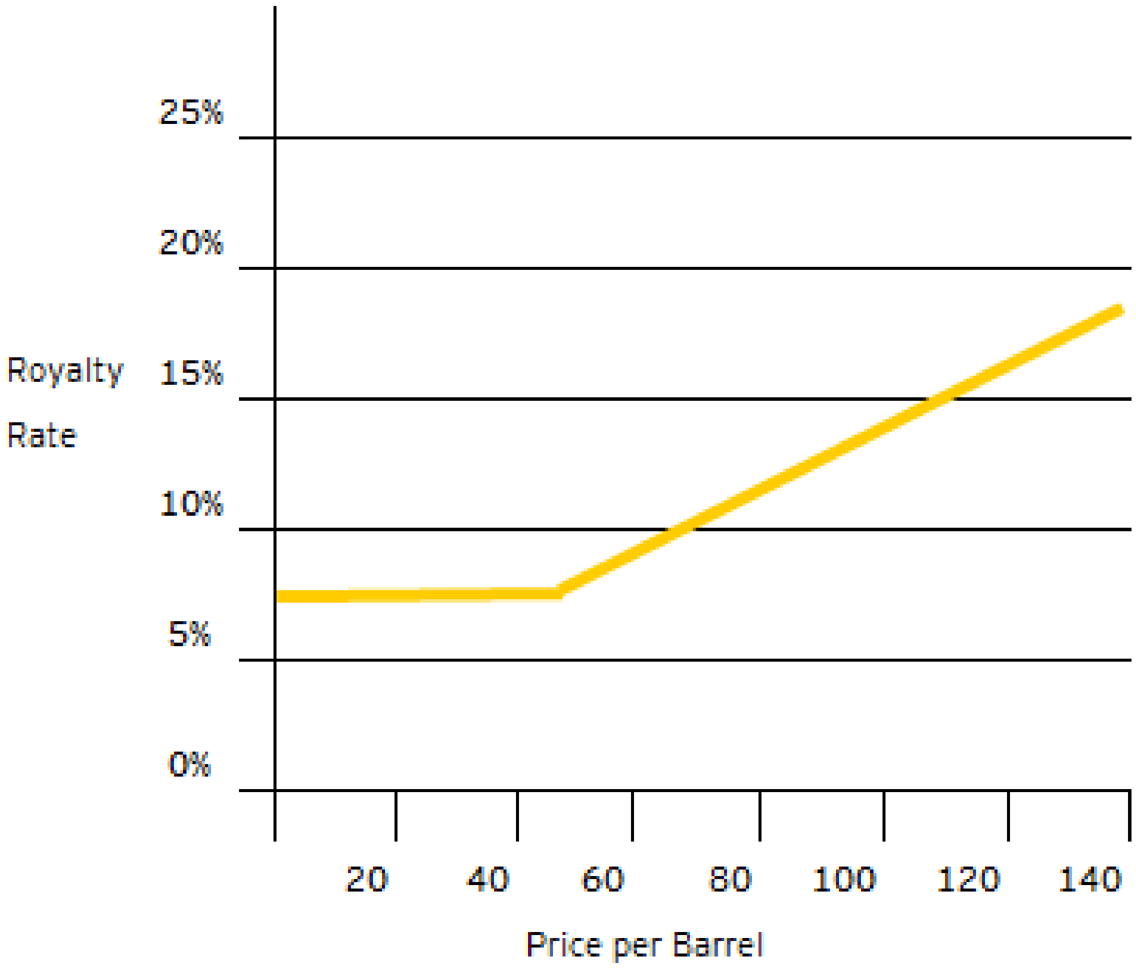
Royalties are payments to the Government based on the gross income derived from oil, gas and condensate production. During the discussions in Congress, only the royalty amount for oil production was increased compared to the Original Bill (royalties for natural gas and condensates were not increased).

This increase in royalty appears to be one of the few negative changes made by Congress to the Revenue Law, as it increases the regressive elements of the compensation formula. While the royalty increase might not have a significant effect on the license agreements, a significant impact in the economics of the profit and production sharing agreements is expected.

Oil royalty. The oil royalty rate is based on the value of the barrel of oil. If the price is under US$48 per barrel, the rate is fixed at 7.5%. If the price per barrel is above US$48, the rate will be increased according to the following formula:

Rate = [(0.125 x Contractual Oil Price) + 1.5] %

As a matter of example, if the price per barrel is US$100, the royalty rate should be 14% (this rate was 10%, in the Original Bill). The following graph shows the new royalty rate:



OIL

Gas royalty. The royalty rate for Associated Natural Gas is still the Contractual Price divided by 100.

On Non-Associated Natural Gas, the formula for determining the royalty starts at US$5 per million BTUs (less than this price is a 0% royalty).

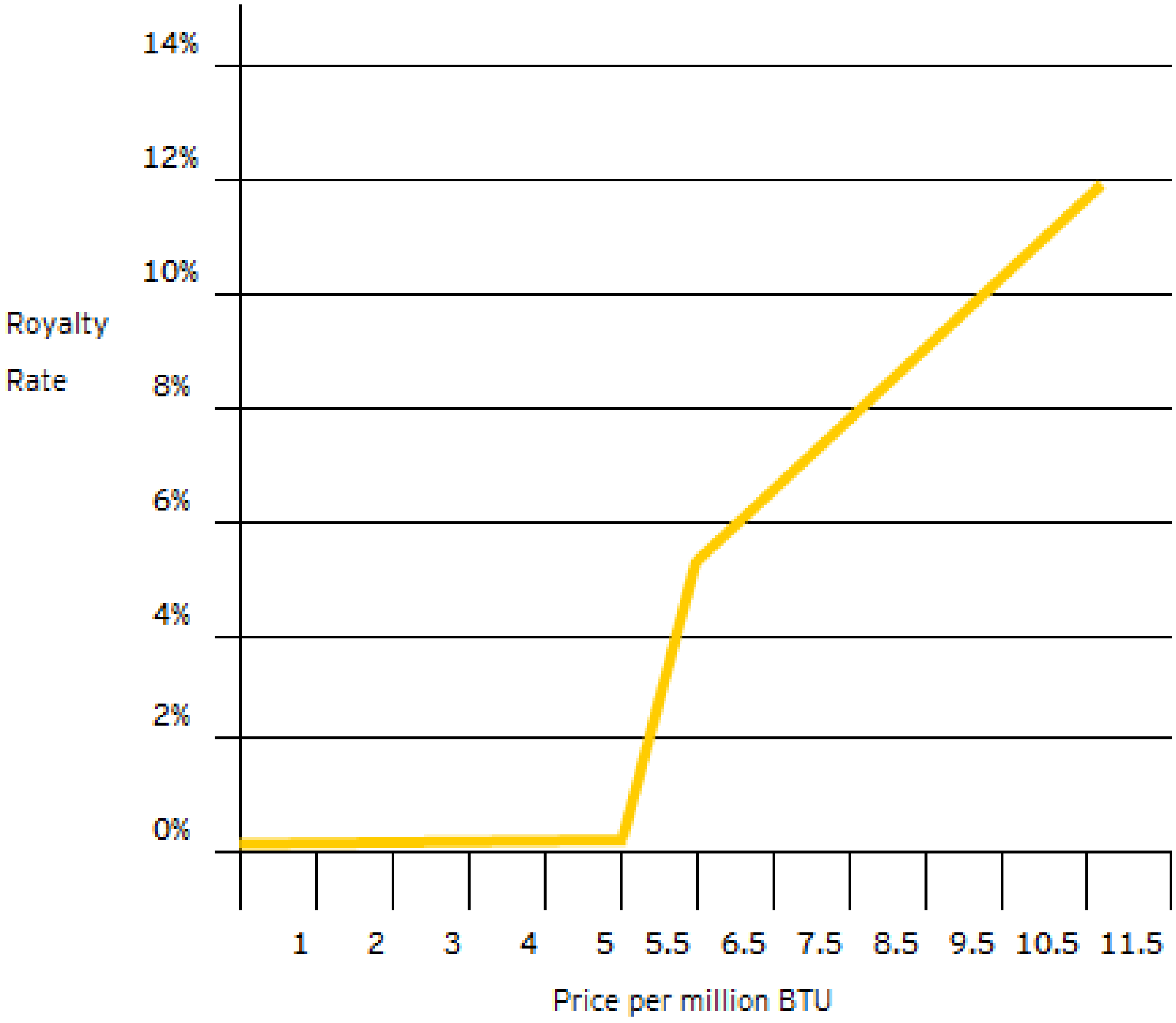
A formula for determining the royalty is given for prices between US$5 and US$5.5:

Rate = [(Contractual Natural Gas Price - 5) x 60.5]

Contractual Natural Gas Price

If the price is more than US$5.5, the formula for determining the royalty rate is the same as for Associated Gas (i.e., Contractual Price divided by 100).

The following graph shows the proposed royalty:

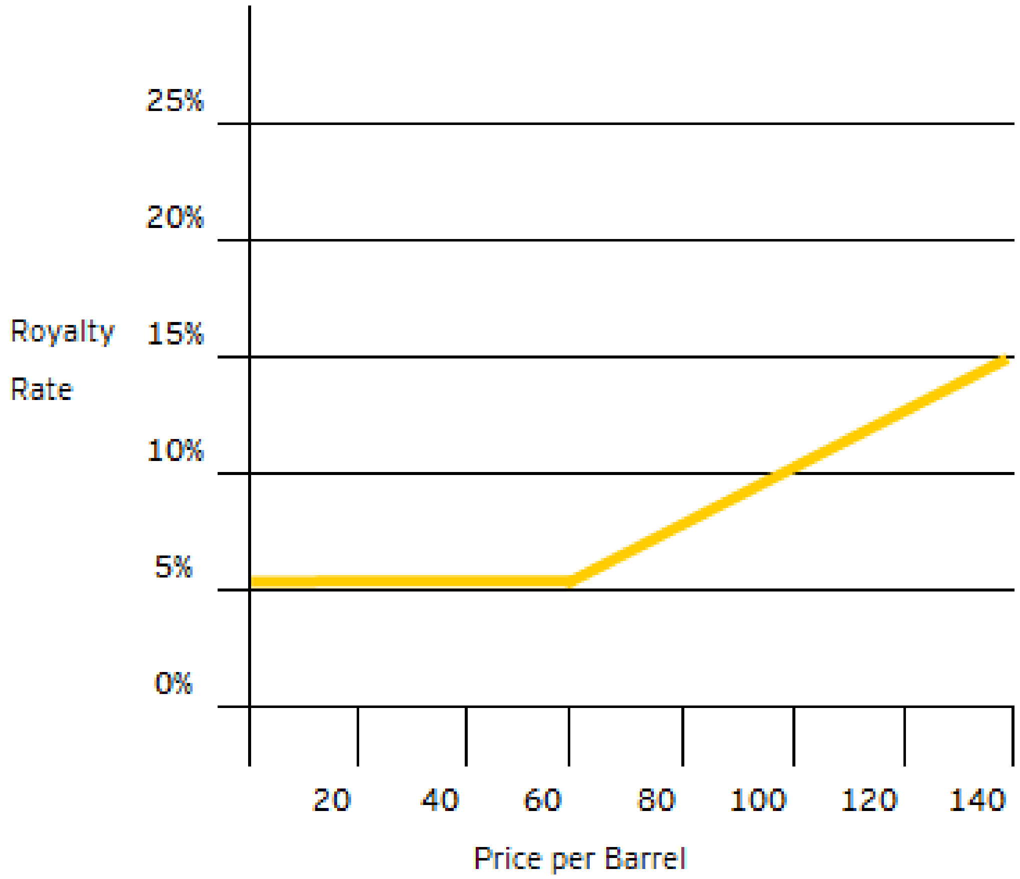


GAS

Condensates royalty. With respect to condensates (i.e., natural gas liquids formed primarily by pentanes and heavier components of hydrocarbons), a progressive rate is established based on the price of the condensates. Under US$60, the royalty rate will be fixed at 5%. Over US$60, the following formula applies for determining the royalty rate:

Rate = [(0.125 x Contractual Condensate Price) – 2.5]%

The following graph shows the proposed royalty:



CONDENSATES

CQEP
The CQEP is a periodic payment that is made before extraction activities begin. The final amount of the quota was reduced in the Revenue Law compared to the Original Bill, mainly because new taxes were included in the Revenue Law, which will go to states and municipalities.

The CQEP for the first 60 months is $1,150 MXP (approximately US$85) per square kilometer, and increases to $2,750 MXP (approximately US$205) thereafter.

Compensation depending on the type of contract

License agreements
The Original Bill foresaw that license agreements could result in different types of payments from the contractors to the Government: upfront signing bonus, CQEP, royalties, and compensation based in a percentage rate over the net operating profit or the value of hydrocarbons.

After its discussion, Congress removed the "net operating profit" criteria, leaving the compensation to be paid to the Government based only on a percentage rate of the value of hydrocarbons, best known as "over-royalty."

Congress also incorporated the possibility of executing production and profit sharing agreements without compensation to the contractor based on cost recovery, which economically speaking would have the same result as the proposed license agreements with the "net operating profit" criteria that were not approved by Congress.

Therefore, under the Revenue Law, when the Government enters into a licensing agreement with a contractor, it may receive upfront signing bonuses, CQEP, royalties and payments based on the value of hydrocarbons. In exchange, contractors will receive the extracted hydrocarbons.

Bonuses will consist of a lump sum payment made upon signing of the licensing agreement. The lump sum amount will be determined by the Ministry of Finance on each contract and will be revealed during the bidding process.

Profit sharing and production sharing agreements
Under profit sharing and production sharing agreements, the Government may receive CQEP, royalties and payment based on the net operating profit. The contractor may receive cost recovery and compensation based on the remainder of the net operating profit.

Different from the Original Bill, the approved Revenue Law considers a clear set of rules for computing the compensation applicable to the profit sharing and production sharing agreements – a positive change for sake of clarity.

In a profit sharing agreement, all of the production shall be delivered to the State's marketer, who shall deliver the proceeds of the sale of such production to the Mexican Petroleum Fund (Petroleum Fund). In a production sharing agreements, the contracts will include which portion of the production should be delivered to the State's marketer, who shall deliver the proceeds to the Petroleum Fund. The Petroleum Fund will receive and distribute the payments that correspond to the Government and contractor.

The net operating profit is determined by subtracting from the value of the hydrocarbons, the amount of royalties paid by the contractor, plus the payment derived from the costs and expenses recovery.

Regarding depreciation rates, the Revenue Law provides more attractive rates than the Income Tax Law, which may be applied during the period:

- 100% of original investment amount for exploration, secondary and enhanced oil recovery, non-capitalized maintenance
- 25% of original investment amount in the exploration and development of oil and natural gas deposits
- 10% of original investment amount made in infrastructure for storage and transport required for the execution of the contract, such as oil and gas pipelines, terminal, transportation or storage tanks required for the contractual production.

The amount of costs, expenses and investments that may be deducted in each period may be limited, but such limitations will be established when the contract is entered into.

Costs and expenses recovery.
The Revenue Law states that profit sharing and production sharing agreements may exclude the costs and expenses recovery clause. However, if a costs and expenses recovery clause is included, the percentages of recovery will be provided in the specific contract based on the guidelines to be issued by the Ministry of Finance. Once included, the expenses recovery clause may not be modified during the contract life.

If a contractor transfers assets whose cost was already recovered, the profits received should be transferred to the Government, or an equivalent amount will be deducted from the payments made to the contractors. This provision may create distortions for depreciation and value-added tax (VAT) purposes for which it will be necessary to analyze income tax and VAT effects.

In computing the cost and expenses recovery, the following items will be considered non-deductible: (i) financing costs; (ii) costs derived from negligence or fraud; (iii) donations; (iv) costs & expenses derived from easements and acquisition of land or rights over land (including legal hydrocarbons easements constituted under the Hydrocarbons Law); (v) non-approved advisory services; (vi) cost from non-compliance of the relevant provisions including risk administration; (vii) unqualified training expenses; (viii) cost from non-compliance of warranties conditions; (ix) expenses for the use of owned technology unless proven to be arm's length; (x) most provisions and reserves; (xi) legal fees; (xii) broker fees; (xiii) royalties and contractual payments during the exploration phase as well as payments of compensations, costs, expenses and investments related to other contracts; and (xiv) those not strictly necessary for the execution of the contract.

Services agreements
Regarding Services Agreements, the Revenue Law adopted the provisions in the Original Bill. Thus, the compensation in these contracts is cash and is based on the industry standards and customs.

Adjustment / R Factor
License agreements and profit sharing and production sharing agreements may include an adjustment factor that will be based on the rate-of-return of each project. The specific adjustment mechanism will be established in the bidding rules and in the contracts.

Structure of investments and ring fencing rules

The Revenue Law provides that bidding rules should only allow contracts to be assigned to entities that meet certain requirements, such as being Mexican residents for tax purposes, having the exclusive objective of the exploration and extraction of hydrocarbons, and not being subject to the Integration (Consolidation) tax regime provided in the Income Tax Law.

Under the approved Revenue Law, Mexican entities, partnerships (*consorcios*) and joint ventures formed by Mexican entities may participate in the bidding process as well, and now each entity may be awarded with different contracts.

This provision, therefore, repealed the ring fencing rule originally proposed in the Original Bill, which required that investors only had one contract awarded per legal entity. Although tax consolidation will not be possible, different contracts may be grouped under the same entity, which appears to be a positive change in the Law.

In the case of consortiums (*consorcios*) (i.e., groups of two or more State Productive Companies and/or legal entities, who jointly submit a proposal in bidding process for the award of a Contract) and joint ventures (*asociaciones en participacion*), the Revenue Law provides for a set of rules for the allocation of income and deductions between members. It is foreseen that consortiums should designate among their members, a member that will serve as the consortium operator. Such operator will be responsible, among other things, for issuing invoices covering the expenses incurred in the execution of the contract.

The members of the consortium - including the operative member- may deduct, individually, their proportional share of costs, expenses and investments, to the extent they are supported by the corresponding invoice issued by the operating member. Also, any amount received by the operating member on behalf of the other members should not be considered taxable income to the extent such amounts are properly documented. Members may opt to receive their payments directly or through the operating member, and should meet their tax obligations individually.

These changes introduced by Congress in the Revenue Law are deemed highly positive.

Economic variable to award contracts

As was provided in the Original Bill, the Revenue Law requires the variable criteria to award contracts to be based in economic factors, which will be included in the bidding rules.

However, now the variables criteria to award contracts will be associated with the amount of compensation that the Government will receive from the contract, plus the initial work and investment commitments made by the investors.

Applicable taxes

The Revenue Law does not establish a new tax regime for contractors, but instead refers to the economic and financial terms and conditions that will be included in the agreements as negotiated by the parties. This means, that the compensation payable under E&P contracts will be independent from the payment of income tax and other indirect taxes that generally apply to legal entities doing business in Mexico.

Although it may seem confusing that the Revenue Law includes changes to various tax provisions, some of the changes are positive, as explained below.

Income tax

Currently, the Mexican corporate income tax rate is 30%, and dividends paid to Mexican individuals and nonresidents are subject to a 10% withholding tax. Mexico has entered into many double tax treaties that may reduce the dividend withholding tax to 0% depending on the place of residence of the shareholder.

Different provisions of the Revenue Law have a direct relation with the income tax law, such as the following:

- The depreciation percentages contained in Article 32 may still be applied, instead of the percentages contained in the Income Tax Law.
- Losses derived from the execution of deep-water contracts may be carried forward for 15 years, instead of the standard 10-year period.
- The expanded definition of permanent establishment (PE) proposed in the Original Bill is maintained. That definition makes nonresidents performing any activity under the Hydrocarbons Law in Mexican territory for more than 30 days in any 12-month period a PE in Mexico.
- Nonresident employees (expatriates) that receive any compensation, such as salary or wages, paid by nonresidents without a PE in Mexico related to a contract or activities under the Hydrocarbons Law performed in Mexico for more than 30 days in any 12-month period will be subject to income tax in Mexico.

VAT

The Revenue Law includes a new provision under which any activity that requires compensation to be paid between the contractor and the Government will be subject to a 0% VAT rate. However, this provision does not apply to other contracts entered into between the contractor and third parties.

The Original Bill would have caused payments made from contractors to the Government to be subject to VAT under the current VAT Law, as such payments would have been deemed as "services."

This modification eliminates the adverse cash effect that would have been triggered in the recovery of VAT on payments made by the contractors to the Government.

Contractors are entitled to recover the input VAT charged by their suppliers for the provision of goods and services, as well as VAT paid upon the importation of goods and services, as the activities that contractors will perform will be taxed at the 0% VAT rate.

Tax on exploration and extraction of hydrocarbons activities

The Revenue Law creates a new tax on exploration and extraction of hydrocarbons activities and it is computed in a similar manner as the CQEP. The tax during the exploration phase will be $1,500 MXP (approximately US$112) per square kilometer and $6,000 MXP (approximately US$450) per square kilometer during the extraction phase. This tax should be paid monthly. The amount will be adjusted on a yearly basis.

The amounts collected from this tax will be allocated to a public fund created for such purpose, and such amounts will be distributed to states and municipalities through certain rules that are set in the Revenue Law.

Profit sharing (PTU)

The Original Bill provided that contractors' profits would not be subject to profit sharing with employees, although a bonus or other incentive could be established for the employees. This provision was removed in the Revenue Law, for which the profit sharing with employees remains applicable under the labor legislation.

Compensation for the acquisition or the temporary use of land

The Hydrocarbons Law establishes a special procedure for the acquisition by contractors of land or rights to use land when required to perform E&P activities under a contract.

This procedure is designed to begin with a letter of intention signed by the contractor, revealing its intention to acquire, lease, constitute a voluntary easement, etc. over the land. The means of acquisition (e.g., purchase, lease, voluntary easement, etc.) should be the most appropriate for the project, and the contractor should reveal the project to the land owner, describing its effect and respond to any queries the affected party may have. The Ministry of Energy may assign social witnesses to verify the negotiation process.

The consideration that will be paid to landowners shall cover the following: a) encumbrances over goods or rights that are different from rights over lands; b) foreseen damages calculated on the basis of habitual activity of the property; c) rent for occupation, easement or land use; d) for projects that reach commercial production of hydrocarbons, a percentage between 0.5% and 3% (3% in the case of Non-Associated Natural Gas) of the contractor's income, after payments are made to the Government.

Additionally, the consideration agreed can be paid in cash or by any of the following means: a) contracting commitments to become part of the labor; b) the purchase of manufactured goods or services; c) commitment to be part of projects and developments; d) any other consideration that is not contrary to the law; e) a combination of the above.

Landowners may request the participation of the Agrarian Procurator's office for their assistance during negotiations. If after 180 days no agreement is reached, the contractor may: (i) bring action in federal courts requesting an injunction to constitute a hydrocarbon easement over the land, or (ii) submit a mediation request with the Ministry of Agrarian Development. If the parties agree to mediation, and after such process an agreement is not reached, the Ministry of Energy may request to initiate a process to constitute a hydrocarbon easement through administrative action.

The hydrocarbon easement would comprise the rights for transit of persons, transportation, conduction and storage of machinery and equipment, construction, installation, maintenance of the infrastructure, or performance of any works as necessary for the execution of projects. The easement shall not exceed the term of the contract, and any controversy derived thereof should be settled by Federal courts.

Some agreements may be considered null for abusive, discriminatory, or unduly practices or conduct, intended to influence the decision of the landowners, property or right holder, during negotiations. Agreements also may be null if they contain provisions that provide as consideration a portion of the project's hydrocarbon production, which will remain property of the nation.

Management of fiscal terms of the contracts

The Revenue Law clarifies the participation of the Petroleum Fund and the Ministry of Finance in the administration and monitoring of the economic and financial aspects of the contracts, clarification that appears highly positive.

It also states that the Petroleum Fund will receive and keep record from the contractors the information related to the costs, expenses and investments, as well as the deductions applied. The Fund will also be in charge of receiving the compensation that contractors make to the Government, and computing and making the payments to contractors.

Among other things, the Ministry of Finance will be in charge of: (1) issuing the guidelines and rules for the registry of costs, expenses and investments; (2) verifying that the payments to the Government and contractors are done accurately; and (3) requesting information for any clarifications needed.

It is also notable the Ministry of Finance will be able to instruct the Tax Administration Service (*SAT*) to perform audits to contractors when they deem necessary.

New PEMEX regime

PEMEX Law allows PEMEX to have subsidiaries and affiliated companies. Also, PEMEX and its subsidiaries and affiliated entities will be regarded as public companies that must provide financial information, reports related to all kind of corporate activities, annual reports, among others.

However, PEMEX will be subject to the Federal Law to Access to Public Information and Accountability, as any public company is, except from risk and industrial information. Such special regime is implemented in order to make PEMEX a highly competitive company.

The Mexican Congress will determine and approve the budget allocated to PEMEX and its subsidiaries and affiliated companies. However, PEMEX will have autonomy and freedom to distribute and invest in projects authorized by its board of directors. PEMEX securities will not be guaranteed by the Mexican Government.

Every year, PEMEX will send a funding proposal (including subsidiaries and affiliated companies) to the Ministry of Finance in order to be included and approved on the Federal Revenue Law.

Contracts originally assigned to state productive companies such as Pemex will be converted to license agreements and those contracts will ensure that the Government does not receive a lower amount of profits compared to the profits that were received under the original contract.

As for the accountability and control regime, the Revenue Law provides that the Petroleum Fund will be bound to provide the certain information related to any agreement executed by PEMEX or its subsidiaries or affiliated companies, such as: hydrocarbons produced volume, general revenues, compensation amount, royalty and CQEP revenues, fiduciary fees, revenues derived from the commercialization of hydrocarbons, investments amounts, etc. The Petroleum Fund revenues will be considered as federal revenues and will be subject to federal audit powers. Mechanisms and control process, registration and tracking will be implemented in order to guarantee that such funds are used for authorized purposes. Finally, the information will have to be reported every month to the Ministry of Finance.

PEMEX will be subject to income tax on the income derived by E&P activities performed and will be subject to the tax obligations set forth in the Income Tax Law.

As provided by the Constitution, PEMEX may be granted "Allocations" (Asignaciones) by the Mexican State to operate oil field areas. The Revenue Law provides for the possibility for PEMEX to migrate (convert) such Allocations into an E&P contract, in which case the Ministry of Finance will set the economic conditions that will be placed in such migrations.

For the Allocations granted, PEMEX should pay different considerations to the Government, such as:

- An annual "Profit Sharing Fee" (*Derecho por la Utilidad Compartida*) of 65% of the value of the hydrocarbons - including the consumption incurred by PEMEX - minus the amount of allowed deductions
- A monthly "Hydrocarbon Extraction Fee" (*Derecho de Extracción de Hidrocarburos*), which will be paid similarly to the royalties applicable to the E&P Contracts, as described above (i.e., payments based on the gross income derived from oil, gas and condensate production)
- A monthly "Hydrocarbon Exploration Fee" (*Derecho de Exploración de Hidrocarburos*), which will be paid similarly to the CQEP applicable to the E&P Contracts, as described above (i.e., periodic payments made before extraction activities begin)

The payments from compensation should be delivered from PEMEX to the Petroleum Fund.

For additional information with respect to this Alert, please contact the following:

Mancera, S.C., Mexico City

- Alfredo Alvarez +1 212 773 5936 alfredo.alvarez@ey.com
- Terri Grosselin +1 305 415 1344 terri.grosselin@ey.com
- Rodrigo Ochoa +52 55 5283 1493 rodrigo.ochoa@mx.ey.com
- Manuel Solano +1 212 773 8114 manuel.solano@ey.com
- Koen Vant Hek +52 55 1101 6439 koen.van-t-hek@mx.ey.com

Ernst & Young LLP, Latin American Business Center, New York

- Enrique Perez Grovas +1 212 773 1594 enrique.perezgrovas@ey.com
- Javier F. Noguez +1 212 646 8348 javier.noguez@ey.com

Ernst & Young LLP, Latin American Business Center, Houston

- Oscar Lopez-Velarde Perez +1 713 750 4810 oscar.lopezvelardeperez@ey.com
- Santiago Llano +1 713 750 8376 santiago.llanozapatero@ey.com
- Pablo Cobo +1 713 750 5101 pablo.cobopineda@ey.com

EY | Assurance | Tax | Transactions | Advisory

EYG No. CM4659

ey.com