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THE PROPOSAL TO AMEND PEMEX'S TAX REGIME – Is it a good indication of how IOCs will be taxed when Mexico opens up to private investment in the oil sector?

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1. Positions of the main political parties

As you may know from the previous edition of the Energy Law Advisor, the three main political parties in Mexico have submitted proposals to the Mexican Congress aimed at reforming the oil and gas sector. They all agree that change is needed in order to, among others things, avert a continued decline in Mexican oil production, increase oil revenues and improve Pemex's efficiency.

The right wing National Action Party (PAN) proposed to amend the Constitution in order to allow the granting of concessions for exploration and production. The President (from the Institutional Revolution Party, PRI) proposed a constitutional reform to allow the State to award exploration and production sharing contracts to private companies, but to keep the prohibition against granting concessions. Both PAN and PRI proposed fully opening the midstream and downstream sectors to private participation. The left wing Democratic Revolution Party (PRD) did not propose a constitutional reform. Instead it submitted an extensive proposal to improve Pemex's governance and accountability, and provide it with more decision-making powers and budget autonomy.

The PAN's proposal is regarded by specialists as the necessary one, and the PRI's proposal as the more feasible one. The President's proposal does not clarify whether the contracts to be awarded would be profit sharing contracts or production sharing contracts, leaving such decision to secondary legislation (which may pass with a simple majority as

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opposed to the two-thirds majority required for constitutional reforms). When announcing the submission of the constitutional reform proposal, the Minister of Energy mentioned that they envisaged profit sharing contracts; however, a PRI official who heads the energy committee in the lower house of Congress recently said that they are not closed to any particular contractual scheme.

The PRD's proposal assumes that Pemex will continue to handle the whole industry on its own, provided it is allowed to operate more like a private company. Nonetheless, many of the changes proposed by the PRD could be beneficial and pass regardless of or in addition to a constitutional reform.

The PRI and the PAN alone have sufficient seats in the Chamber of Representatives (*Cámara de Diputados*) to push through a constitutional reform. They along with another small party (an ally of the PRI during the presidential election) have enough votes in the Senate to pass a constitutional reform. Therefore, a constitutional reform ending Pemex's seven-decade monopoly is very likely to pass, possibly before the end of 2013.

The PRI has gone to great lengths to publicize the benefits of their reform proposal and even to defend its legitimacy from President Cardenas' ideological perspective (the president who nationalized the oil industry in 1938). Yet, a constitutional reform still faces opposition from large numbers of Mexicans for nationalistic and sovereignty reasons, as much as from fears of potential lack of competition, transparency and probity in how the new exploration and production contracts or concessions would be awarded.

The PRI along with the PRD recently approved an important overhaul of the Mexican tax system, to which the PAN opposed. This strained PRI-PAN relations and PAN officials have mentioned that: (i) a reform to the electoral process has to be passed first (it is currently being discussed in Congress); and (ii) the PRI has to provide oil companies with greater incentives to win the PAN's support for an energy reform.

The original proposal amending the tax system included a proposal to amend Pemex's tax regime. Such proposal was put on hold in Congress in order to review it together with the energy reform proposal. As we explain below, the proposed tax regime may serve as an indication of how the current administration envisages taxing private oil firms.

2. Current tax regime for Pemex's exploration and production activities

Pemex is subject to a very complex, administratively burdensome, rigid and onerous tax regime providing for numerous special governmental fees applied to its gross and net income, and allowing only limited deductions. The regime does not even allow Pemex to decide whether to reinvest its profits or pay dividends to the State.

Each of Pemex's subsidiaries is taxed differently. Exploration and production projects are taxed on a different basis depending on the relevant type of field (eg. marginal fields, deep-

water fields, etc.) or product (eg. natural gas or crude oil). According to the statement of intent of the tax reform proposal, around 97% of Pemex's crude oil production is taxed under a so-called "general regime", under which Pemex has recently (2006-2012) paid taxes amounting to 68% of its gross income or 90% of its net income.

Under the "general regime", cost deductions are limited to USD 6.5 for each barrel of oil produced. Costs in excess of that amount cannot be carried forward to the following year. The regime does not take into account inflation, higher costs due to high oil prices, or the fact that costs may vary from time to time.

The regime is meant to incentivize Pemex to keep costs low, but it actually causes severe distortions. Most importantly, it causes some projects to become artificially more profitable than others, which in turn provides Pemex with incentives to carry out the projects that make sense from the standpoint of its tax regime, as opposed to those that make sense business-wise. This partly explains, for instance, why Pemex has not developed as many natural gas projects as the country's economy really needs.

3. The proposed tax regime for Pemex

The new regime is intended to be a simple, flexible, transparent and standard one, allowing Pemex to pay income tax more like private companies do and to deduct its real costs. It would be a progressive regime that would enable Pemex to recover its exploration and production costs while allowing the State to increase its oil revenues as operating profitability increases.

Under the new regime the State's oil revenues (Pemex's income tax aside) would derive from: i) a royalty on sales; and, ii) a percentage tax on profits at a rate to be contractually determined on a per project basis (Pemex being the State's contractor under a profit sharing contract).

The proposal anticipates that the Ministry of Energy would award profit sharing contracts to Pemex as opposed to granting licenses (*asignaciones*).

The State would still decide the amount of dividends to be paid to it. The President would propose the size of the dividend and the Congress would approve it. The remaining profits would be reinvested as Pemex's Board of Directors deems appropriate.

In order not to affect the State's revenues adversely, the new regime would be implemented gradually (oil revenues still account for over 30% of the federal government's budget). Accordingly, some of the existing projects would continue to be taxed under the current regime, while the rest of them and all of the new projects would be taxed under the new regime.

The new oil and gas exploration and production taxes would be paid as follows:

i) A monthly fixed MXN 2,650 (approx. USD 203) fee per square kilometer of surface for an awarded block during the exploration phase. The fee would be increased to MXN 4,250 (approx. USD 326) after the 61st month following the execution of the relevant contract.
ii) A percentage of the gross contractual value of the produced hydrocarbons to be paid monthly or for an agreed period. The percentage would increase progressively as the contractual price of the hydrocarbons increases. For crude oil the applicable rate would be 5% when the contractual price is below or equal to USD 60 per barrel. When the contractual price is higher, in order to calculate the applicable rate, the price in excess would be multiplied by 0.125% and the result added to the 5% rate.
iii) A percentage of the operating profits to be determined as stipulated in the relevant profit sharing contract. Operating profits would be based on the contractual value of the hydrocarbons (as opposed to their actual sale value). The contract would include an adjustment mechanism in order to increase the State's oil revenues as the project becomes more profitable (due to cost reductions, productivity improvements or increases in oil prices).

The non-taxed portion of the operating profits would become Pemex's (as contractor) profits. Therefore, the tax structure should be established so as to permit the contractor to recover all of its recorded, invested capital and operation and maintenance costs.

Although the new scheme provides for a percentage limit to the invested capital and operation and maintenance costs to be recouped by the contractor, the limit is merely meant to modulate the pace at which those items are going to be recouped without restricting their full recognition over time.

All of the sales of oil produced by the project would be conducted by a State-owned trader appointed by the Ministry of Energy. The consideration for the sale would be paid directly to a trustee (a development bank owned by the State), which would be in charge of transparently calculating the operating profits from the project and distributing the funds in terms of the relevant profit sharing contract. The trader's and trustee's fees would also be paid by the trustee from the trust funds.

4. Final remarks

The proposal envisages that the Ministry of Energy will award profit sharing contracts to Pemex and does not contemplate the awarding by Pemex of such contracts to private contractors. This may be because the proposal was originally meant to be part of the tax reform proposal and independent from the energy reform proposal. But that may also be meant to allow a special tax regime to be already in place for private oil and gas producers when the energy reform passes. It might be less controversial now to discuss a new tax

regime for Pemex than a tax regime for private oil and gas producers (who have been banned from exploration and production activities for decades).

As mentioned above, the Minister of Energy initially mentioned that profit sharing was the scheme they planned to use. If this turns out to be the case when the energy reform passes, the proposal to reform Pemex's tax regime may serve as a good indication of how the Mexican federal government plans to tax private oil and gas producers when Mexico opens up to private investment in the oil and gas sector. It is reasonable to assume that, when that happens, Pemex and private oil and gas producers will be expected to compete on even terms. Unfortunately, the tax reform proposal cannot give us a clearer picture because it could not contain the rules necessary for determining how the tax rate on operating profits would be set during a public procurement procedure with private bidders.

If production sharing contracts are allowed instead, then the current proposal would need to change to a greater extent. For instance, a State-appointed trader would not be necessary and taxes would not be calculated on the basis of contractually agreed oil and gas values. Nevertheless, the current tax reform proposal is a useful document to analyze the Mexican Ministry of Finance's intentions in view of the upcoming historically important energy reform.