Mexico's President submits secondary legislation to Congress related to the energy reform

On 30 April 2014, Mexico's President Enrique Pena Nieto submitted to Congress a package of laws comprising the secondary legislation related to the recently approved energy reform. These laws will allow for the implementation of the energy reform, which was started in December 2013 through constitutional amendments and opened the door up to private investment in the energy industry. Included in the package are certain rules related to tax and other fees to be paid to the government, along with additional regulatory guidance. This Alert focuses on the taxes and other fees.

Background

In December 2013, as part of a sweeping energy reform, the Mexican Constitution was amended to loosen the restrictions on the industry. These constitutional amendments represented a landmark change for Mexico's state-owned hydrocarbon resources and served 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 electricity, natural gas and geothermal.

The secondary legislation submitted to Congress constitutes the implementation of the energy reform; it includes modifications to 13 existing laws and foresees the creation of 8 new laws. This package of laws is expected to be debated and voted on by Congress during extraordinary sessions that will be held in June. There are detailed rules about certain calculations that should be analyzed in order to fully understand the economic effect and the government take on these hydrocarbon investment and other contracts.

General overview

The secondary legislation provides the legal framework for the opening up of the energy industry. The Ministry of Energy would oversee the industry as a whole and would approve the technical aspects of the privatization. The Ministry of Finance would oversee the financial and economic aspects of the implementation with respect
to the bids, as well as financial compliance with the contracts that are eventually issued. Further, the reform would create a National Hydrocarbon Commission (CNH by its Spanish acronym), which would oversee the hydrocarbon aspect of the industry, including the request for bids analysis and awarding of the bids. Much of this process has been handled by Pemex (Petroleos Mexicanos) historically.

In general terms, the secondary legislation relies on the principle that unextracted hydrocarbons remain the property of the Mexican State. However, the proposed secondary legislation provides a roadmap for free and open competition between state-owned companies (i.e., Pemex) and private companies, for the exploration and production of oil and gas, as well as for transformation, logistics, and other energy related activities.

The package of secondary legislation includes the following new laws:

**Hydrocarbons Law.** This cornerstone statute would establish the overall framework by which the exploitation of hydrocarbons may be performed. It would provide rules for the types of contracts that will be granted for exploration and production to the industry operators, as well as for transformation, logistics, and other energy related activities.

**Pemex Law.** This law would reorganize Pemex’s activities, and seek to transform Pemex into a productive state company. It would provide regulations for corporate governance, as well as audit and assurance, among other changes to Pemex’s current structure.

**Electricity Industry Law.** This law would regulate the generation, transmission, distribution, and commercialization of power and electricity, as well as set obligations for industry members on issues such as clean energy, open access, supply, among others.

**Petroleum Fund Law.** This new law would establish and regulate a state-owned fund that would 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.** This new law would create a decentralized agency that would regulate and monitor the industrial, operational and environmental protection, related to the locations and activities of the hydrocarbons sector.

**Geothermal Energy Law.** The exploitation of geothermal resources located in the subsoil, which includes the participation of private investors through the granting of permissions and concessions would be regulated through this law.

**Energy Regulatory Law.** This law would create 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.

**Tax and fiscal regime**

As for the fiscal regime (oil revenues and taxation), the new regulations are contained in the Law for Revenue of Hydrocarbons (Revenue Law). The Revenue Law would establish that contractors would continue to be subject to the general federal taxes, including income tax and value added tax (VAT) and also would establish the additional types of fees, royalties and other payments that would have to be made under the new contracts and activities.

Although there are no proposed amendments directly to the income tax law, the contractors would be allowed to elect depreciation rates provided under the Revenue Law for purposes of calculating their income tax liability.

The proposed Revenue Law would establish the “Compensation” (Contraprestacion) to be paid to the Government for different types of contract. Under a specific provision, contractors would not be exempt from other tax provisions, including VAT. As such, it appears that these Compensation amounts could be subject to VAT. If so, this could result in a significant cash flow issue for the contractors.

Furthermore, the classification of these payments as Compensation appears to be an attempt to take them out of the tax world for purposes of challenges and
interpretations to the rules overall. However, because the Ministry of Finance and the Tax Administration would ultimately be responsible for the financial and economic oversight, it is likely that regulations and interpretations will follow the tax aspects.

The Compensation calculations would depend on the value of the oil as set forth in the agreements. The oil value would be based on complicated rules in the Revenue Law.

For most contracts, there would be four basic types of payments to be considered: (i) an upfront signing bonus; (ii) Contractual Quota for Exploration Period (CQEP); (iii) a royalty based on revenues; and (iv) an Additional Payment based on operating profit or the value of hydrocarbons (Profit Sharing payment). Each of these is described in more detail below.

**Bonus payments**
A bonus payment would be a lump sum payment made upon signing of the contract. The amount of this payment would be determined by the Ministry of Finance in each contract and would be included in the request for proposal documents. The bonus should not be a driver for the bid process and should not be a highly significant amount.

**CQEP**
A periodic payment would be made before extraction activities begin. The quota to be paid would be increased after month 61 in order to incentivize production. This quota would not exempt any property or land ownership from taxes that may otherwise be payable. The quota for the first 60 months would be MXP$2,650 MXP (around US$200) per square kilometer, and $4,250 MXP (around US$320) thereafter.

**Royalties**
Royalties would be payments based on the gross income derived from oil and condensate production. A progressive rate would be established based on the price per barrel of oil or condensate. If the price per barrel is under US$60, the rate will be fixed at 5% and would increase for prices above US$60 according to the following formula:

\[
\text{Rate} = \left[\frac{0.125 \times \text{Contractual Oil/Condensate Price} - 2.5}{100}\right]
\]

The following graph shows the proposed royalty:

With respect to associated natural gas, the formula for the royalty percentage is the Contractual Price divided by 100.

On non-associated natural gas, the formula starts at US$5 per million BTUs (less than this price is a 0% royalty). The formula for determining the royalty for prices between US$5 and $5.50 would be as follows:

\[
\text{Rate} = \left[\frac{\text{Contractual Natural Gas Price} - 5}{100}\right] 
\]

If the price is higher than US$5.50, the formula for associated gas would be used.
The following graph shows the proposed royalty:

In addition, the following costs and expenses would be non-deductible for the net profit calculation subject to the Profit Sharing payment: interest and financial costs, costs derived from negligence or fraud, donations, acquisition of land or rights over the land, non-approved advisory services, unqualified training expenses, most provisions and reserves, expenses for the use of owned technology unless proven to be arm's length, royalties and contractual payments during the exploration phase, among others including items specifically included in the contracts.

Contracts
As a result of the overall reform, new agreements would be established with the Government of Mexico for the industry. In the past, these were primarily service agreements, as well as certain incentive agreements that were limited in nature. There are no limits on the nature of the agreements that can be entered into.

All of the payments described above would be due for license agreements, in which the contractor has the right to the extracted hydrocarbons.

For the Profit Sharing and Production Sharing agreements, whereby the contractor receives a cost recovery and a profit share, the CPEQ and royalties above would be due. The cost recovery under these agreements would be limited to approved expenses and the non-deductible expenses described above would not be recoverable.

The following graph shows the proposed royalty:

**Profit Sharing payment**
The Profit Sharing payment is intended to be the principal revenue mechanism for the state. The payment would be calculated based on a percentage of the operating profits under the contract. The base would be determined by subtracting from the contractual value of the hydrocarbons, allowable deductions including the royalties as described above, as well as costs and expenses incurred. For this purpose, the rules established in the Income Tax Law should generally be followed with certain exceptions.

With respect to this Profit Sharing calculation, the Revenue Law would allow the Government to provide limits on the total amount of deductions taken each year, in which case the excess deduction may be carried forward to future years. In addition, to the extent that a loss is obtained, the loss may be carried forward for 10 years.

The Revenue Law would provide an exception from the use of the Income Tax Law for certain depreciation rates. The Revenue Law would establish the depreciation rates and the contractor would be allowed to elect those rates for income tax as well. The depreciation rates would include:

- 100% for investments in exploration, secondary recovery and improvement and non-capitalizable maintenance
- 25% for investments in the exploration and development of petroleum and natural gas deposits
- 10% of the investment made in infrastructure for storage and transport for the execution of the contracts
For services and other agreements, the Compensation and other obligations would be established under the terms of the agreements.

Contracts that are assigned exclusively to Pemex would be subject to a unique regime, which would represent a change in the way Pemex currently operates.

Other items
As described above, the contractor would be allowed to use the depreciation rates included in the Revenue Law in place of the depreciation rates allowed under the Income Tax Law. Some of the investments contemplated in the Revenue Law are not specifically contemplated for income tax purposes.

Ring fence rules are being proposed, which would limit private contractors to one contract per legal entity and those entities would not be entitled to apply for the Integration (Consolidation) Tax Regime provided in the Income Tax Law. As such, each contract would be subject to taxation on a separate entity basis.

The profits of the contractors or assignees would not be subject to profit sharing with employees; however, a bonus or other incentive may be established for the employees.

The Revenue Law would include an expanded definition of permanent establishment, which would also be applicable for income tax purposes for nonresidents performing any activity under the Hydrocarbons Law in Mexican territory for more than 30 days in any 12-month period.

Oversight of the calculations of the Rights and Compensation would be handled by the Mexican tax authorities.
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