In Production Sharing Contracts (“PSC”), a significant portion of the contractor’s income comes from cost recoveries, while the remaining portion comes the operating profits earned by the contractor in accordance with the terms of the PSC.

Recoverable costs comprise costs that are strictly indispensable for the hydrocarbon exploration and extraction activities in terms of the PSC. All cost recoveries must meet a series of requirements of both substance and form, and failure to meet these requirements could jeopardize the contractor’s ability to recover the costs and consequently, to receive this income.

For purpose of cost recoveries, the PSC establishes that these costs must meet certain cost recovery and accounting procedural and reporting requirements (as contained in Annex 4 and 11 of the PSC). Those procedures require the contractor to maintain accounting records prepared in accordance with specific accounting rules (i.e., accrual accounting in Mexican pesos in accordance with Mexican GAAP and Mexican tax law regarding electronic accounting) and to submit reports to the National Hydrocarbons Commission (CNH Mexican acronym) prepared following specific criteria different from Mexican GAAP (i.e., cash flow basis accounting and amounts in US dollars in terms of the Mexican Oil Fund electronic reporting system).

Additionally, the contractor’s ability to execute cost recoveries is strictly dependent on the contractor’s correct preparation of the project program cost budgets that are subject to CNH approval, since any amounts that exceed the budget are effectively non-recoverable. This is why contractors should take steps to ensure close compliance with these guidelines (charts of accounts, payment schedule, basis for preparation and consistency with Project Programs and Plans). Likewise, to be able to execute their cost recoveries, contractors must also comply with the Procurement Rules (Annex 10 of the PSC).

These rules are essentially designed to ensure that the contractor’s goods and service procurements are conducted at fair market values (applies to both related party and third party transactions). It is also important to note that the Cost Recovery Procedures establish specific rules and processes for related party procurements.

How EY can help

EY can give you the peace of mind that your organization will meet all of these cost recovery requirements to ensure that it receives this income.

EY may assist you in preparing the cost budgets subject CNH approval or in setting up the systems that your organization needs to comply with the accounting and cost recovery procedural and reporting requirements and the Tax Administration Service (SAT) reporting requirements.

We may also assist your organization by reviewing any other cost recovery requirements, including those related to transfer pricing issues, delivery of support documentation, and identification of eligible costs and subsequent recoverable costs.

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