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Legal Update
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Mexico's President Proposes New Hydrocarbon Revenues Law with Tax Reform Package

Mexico's President, Enrique Peña Nieto, recently delivered his 2014 tax reform package to Congress. The package covers a broad range of tax and budgeting proposals that will affect many sectors of the Mexican economy. This update provides an overview of the portion of the tax reform proposal that affects the hydrocarbons sector.

President Peña Nieto's proposal on tax reform, which affects the entire Mexican economy, is not as sweeping as many had expected. Overall, the reform package seeks to strengthen government revenue and growth by increasing corporate and individual income tax rates, establishing stock exchange capital gains and dividend taxes and eliminating permitted deductions and exemptions. The provisions directed to the hydrocarbon sector are, however, a bit more significant inasmuch as they seek to reduce the tax burden on state-owned oil company Petroleos Mexicanos (PEMEX) while increasing government revenue through other tax measures. As part of the tax reform package, President Peña Nieto proposed a Hydrocarbon Revenues Law (*Ley de Ingresos Sobre Hidrocarburos*) that would establish a new fiscal regime for the state hydrocarbon earnings and PEMEX's exploration and productions activities. The specific features of this significant tax reform are discussed in more detail below.

First, with the introduction of a profit-sharing regime applicable to PEMEX's activities, the proposed law seeks to lessen PEMEX's tax burden, which last year represented an effective tax rate of 99 percent. Because of the nation's economic dependence on oil profits, this will not happen overnight. Nevertheless, the proposed hydrocarbon revenues law provides a roadmap for decreasing this dependence and granting financial and operational freedom to PEMEX so that it may act more like an independent company. As such, PEMEX would be able to more adequately contract with third parties to embark on higher risk/higher reward programs and more challenging projects such as deepwater, ultradeep water and shale gas development activities.

Second, the profit-sharing regime seeks to strengthen the current exploration and production fiscal regime by incentivizing PEMEX to produce more. Through the imposition of a surface fee applicable to non-producing areas as well as the profit-sharing regime, PEMEX would be economically incentivized to increase production and thus act more like a private operator. As PEMEX becomes more production-focused, more opportunities for the private sector would certainly arise, including associations and joint ventures with PEMEX.

Third, although the proposed law does not refer to private parties, it does provide a glimpse of what a profit-sharing regime could look like for the private sector. The proposed law establishes a trust that is in charge of the allocation of hydrocarbon profits between the government

and PEMEX. This trust would logically also be in charge of distributing hydrocarbon profits to private parties under profit-sharing contracts. The establishment of a trust, administered by an third-party agent, introduces a degree of transparency in the distribution of oil profits. The fiscal and other relevant terms applicable to private investor participating in exploration and production activities in Mexico will need to be established by secondary legislation and regulation.

Finally, through the proposed profit-sharing regime, the Ministry of Energy would have flexibility to vary the profitability of distinct contractual areas to attract the required investment and technology needed for each particular contract area. Under the current assignation regime, the fiscal terms applicable to PEMEX are established by law, and, thus, PEMEX and the Executive Branch (including the Ministry of Energy) have little control over them. Under the proposed regime, the Ministry of Energy will be able to control the profitability of each particular project through the issuance of rules and adjustment mechanisms on a contract-by-contract basis.

The Mexican Congress has commenced the review of this tax reform package. The Hydrocarbon Revenues Law, if passed, would become effective on January 1, 2015.

The main features of the proposed Hydrocarbon Revenues Law are summarized below.

Government Dividend from PEMEX

The proposed Hydrocarbon Revenues Law establishes a new "state dividend" provided by PEMEX and its subsidiaries to the federal government. After the delivery of a financial report by the PEMEX board of directors, the executive branch of the federal government will then propose a state dividend amount to Congress. Any amounts remaining after the payment of the state dividend could be then reinvested in PEMEX's activities as determined by the PEMEX board of directors. The proposed Hydrocarbon Revenues Law establishes that the state dividend shall be gradually decreased through the years. Specifically, the state dividend in 2016 shall be at least 30 percent of PEMEX's earnings after taxes but shall be reduced to 15 percent in 2021 and to zero starting from 2026.

Fiscal Regime for Exploration and Production Activities

The proposed law establishes that exploration and production activities shall be conducted either by direct assignations granted to PEMEX (which is the current regime) or through a new regime involving profit-sharing contracts entered into between the government and PEMEX. Each of these regimes would impose different fiscal terms on PEMEX's exploration and production activities.

1. ASSIGNATIONS

PEMEX currently holds "assignations" on contractual areas with specific fiscal terms mainly determined by the current Federal Law on Fees (*Ley de Federal de Derechos*). Pursuant to the proposed law, PEMEX will keep the current assignation areas under the current fiscal regime.[1] However, the law proposes a transition plan to migrate from assignations to profit-sharing contracts. This migration shall occur on a gradual basis so as not to significantly affect the state hydrocarbon earnings that currently finance a significant part of the federal budget.

2. PROFIT-SHARING CONTRACTS

The proposed law provides that the sale of hydrocarbons extracted pursuant to the new profit-sharing contracts between the government and PEMEX shall be conducted by a "State Sales Agent" (*Comercializador del Estado*), to be engaged by the Ministry of Energy, which shall then deliver all of the earnings derived from such sales to a newly

established trust pursuant to rules to be established by the Ministry of Energy.

For transparency and administrative purposes, the law proposes establishing a trust, which shall receive and administer all earnings received from the sale of hydrocarbons under profit-sharing contracts, and which shall publish the corresponding prices, volumes and earnings of each contract. The trust shall distribute the payments applicable to the federal government and to PEMEX, and any other payments due pursuant to the rules to be established by the Ministry of Energy.

The law contemplates that PEMEX or its subsidiaries and the federal government shall enter into contracts (each, a "State Contract") for the performance of exploration and production of hydrocarbons for each specified contract area and for a specific duration. The proposed law establishes that the State Contracts shall include the following terms:

a. **A monthly surface rental fee**[2] to be paid by PEMEX to the federal government, applicable to non-producing contract areas. This rental fee would enable the government to receive positive cash flow before production and would incentivize production. This fee would increase after month 61 of the applicable State Contract.

b. **A production royalty rate**[3] to be calculated and paid by the trust to the federal government on the gross value of each type of hydrocarbon (crude oil, natural gas and condensates) produced, which rate shall increase with the contractual price of the particular hydrocarbon so that the government receives a proportionally higher amount of the hydrocarbon value when prices increase.

c. **A share of the operations profits** to be paid by the trust (a) to the federal government pursuant to its entitled share in the State Contract and (b) to PEMEX or subsidiaries pursuant to pre-established percentages in each State Contract, taking into account the deduction of eligible costs from the contractual value of the hydrocarbons (which shall be published by the trust) as established in more detail by the law. In calculating the operations profits, the contractual value of the hydrocarbons in the applicable period shall be decreased by (a) the payment production royalty rates (described in point 2 above), (b) the trust costs for administering the particular State Contract and (c) the costs, expenses and investments pursuant to the rules published by the Ministry of Energy; provided, however, that the aggregate decreased amount shall not exceed the limit of cost recovery established in each corresponding State Contract.

   These allocations of operating profits shall be subject to an adjustment mechanism pursuant to the corresponding State Contract and as determined by the Ministry of Energy, which mechanism will seek to ensure the profitability of each State Contract.

d. **Corporate income tax** (currently 30 percent) to be paid by PEMEX and its subsidiaries, as applicable to any other corporation in Mexico, which would only be applicable to income and costs associated with the profit-sharing contracts between the government and PEMEX. As mentioned, PEMEX's assignations would maintain their current fiscal regime and thus would not be subject to this new corporate income tax.

For more information about the topics raised in this Legal Update, please contact any of the following lawyers.

Dallas Parker
+1 713 238 2700
dparker@mayerbrown.com

Jose Valera
+1 713 238 2692
jvalera@mayerbrown.com

Pablo Ferrante
+1 713 238 2662
pferrante@mayerbrown.com

Gabriel Salinas
+1 713 238 2622
gsalinas@mayerbrown.com

Endnotes

[1] Pursuant to the assignation regime, PEMEX is obligated to make an annual payment, applying a rate of 71.5 percent to the amount resulting from (a) the annual value of crude oil and natural gas extracted during that year less (b) deductions permitted pursuant to the law. This payment is made pursuant to a statement delivered on the last business day of March following the corresponding fiscal year.

[2] The fee during the first 60 months of the State Contract shall be MXN 2,650 per square kilometer or fraction thereof; after month 61, the fee shall be MXN 4,250 per square kilometer or fraction. These amounts shall be updated in January of each year pursuant to the Mexican National Consumer Price Index (*Indice Nacional de Precios al Consumidor*) of the previous year.

[3] In regard to the production royalty fee, the proposal contemplates that the trust shall deliver to the federal government the following percentages of the value of the extracted hydrocarbons per contract area based on the following terms:

For crude oil, the following rates shall apply: (a) 5 percent when the contractual price of the crude oil is lower than US$60 per barrel; and (b) 5 percent plus the result of multiplying 0.125 percent by the difference between the contractual price of the crude oil and US$60 per barrel, when the contractual price of the crude oil is higher than or equal to US$60 per barrel.

For natural gas, the following rates shall apply: for associated natural gas, the result of multiplying the contractual price of natural gas by 1 percent; and for non-associated natural gas, the following: (a) zero when the contractual price is lower than or equal to US$5 per 1 million BTU; (b) the result of the following formula, when the contractual price of natural gas is higher than US$5 but lower than US$5.50 per one million BTU:

$$\text{Rate} = \frac{(\text{Contractual price of natural gas} - 5.00) \times 60\%}{\text{Contractual price of natural gas}}$$

and (c) the amount that results from multiplying the contractual price of natural gas by 1 percent when the contractual price of natural gas is higher than or equal to US$5.50 per million BTU.

For condensates, the following rates shall apply: (a) 5 percent when the contractual price of the condensates is lower than US$60 per barrel; and (b) 5 percent plus the result of multiplying 0.125 percent by the difference between the contractual price of the condensates and US$60 per barrel, when the contractual price of the condensates is higher than or equal to US$60 per barrel.

These payments shall be updated pursuant to United States Producer Price Index (*Indice de Precios al Productor de los Estados Unidos de America*), and based on the rules to be published by the Ministry of Energy.

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