Accountability and transparency

Oil and gas fiscal system in Mexico

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Mexico’s intergovernmental fiscal relations

- Intergovernmental relations in Mexico are characterized by a huge vertical imbalance.
- States derive almost 90% of their total revenue from federal transfers, and this figure is 65% in the case of municipalities.
- The federation provides to subnational governments general transfers (participaciones), specific transfers (aportaciones), as well as revenue from federal taxes, presently administered and collected by the states.
- The existing participaciones were designed to compensate the states for the loss of own-source revenue as the federal VAT replaced a myriad of state taxes (each state’s share was defined on the basis of foregone tax revenues).
- General transfers (participaciones) are derived from a common pool - the Recaudacion Federal Participable (RFP) - constituted by federal assignable taxes (mainly VAT & IT) and oil revenues.
Mexico’s intergovernmental fiscal relations

• 20% of RFP is distributed to states through the General Sharing Fund (“Fondo General de Participaciones”, FGP).

• From 1990 the criteria for distributing “participaciones” to state governments were modified: 45% of FGP was distributed according to population, in order to introduce equity to the system (since it is supposed that a state with a larger population needs more resources to provide public services).

• From 2009 the criteria for distributing “participaciones” were again modified:

\[ P_{i,t} = P_{i,07} + \Delta FGP_{07,t} \left( 0.6C1_{i,t} + 0.3C2_{i,t} + 0.1C3_{i,t} \right) \]

Each state gets the same amount obtained in 2007 \((P_{i,07})\), and the additional FGP is distributed to any given state according to its share in national population, weighted with relative GDP growth \((C1)\), relative growth in own tax collection \((C2)\) and its share on own tax collection \((C3)\).
Mexico’s oil sector

• In 2008, Mexico was the 7th largest oil producer in the world, and the 3rd largest in the Western hemisphere.

• The oil sector is a crucial component of Mexico’s economy: generates between 10%-15% of the country’s export earnings and about 35% of total government revenues.

• Mexico is consistently one of the top three exporters of oil to the US, along with Canada and Saudi Arabia.

• Mexico is not a member of OPEC or any petroleum production related organization.

• The Mexican Constitution provides that the nation owns all petroleum and other hydrocarbon reserves located in Mexico.
Mexico’s oil sector

- Oil and gas industry is regulated at the federal level.
- Since 1938 Pemex is the national oil and gas company.
- Pemex is a vertically integrated company: from upstream operations (exploration, drilling and exploitation of oil and gas), to natural gas processing and distribution, refining and petrochemicals.
- Pemex and its 4 subsidiary entities, are public entities of the Mexican Government, and each is a legal entity empowered to own property and carry on business in its own name.

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1/ Exploration and Production, Refining, Gas and Basic Petrochemicals and Petrochemicals.

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Mexico’s oil sector

- Mexican law grants Pemex-Exploration and Production the exclusive right to exploit Mexico’s hydrocarbon reserves.

- Pemex is the largest company in Mexico, and according to the November 30, 2009 issue of Petroleum Intelligence Weekly, is the 3rd largest crude oil producer in the Western hemisphere and the 11th largest oil and gas company in the world, based on data for the year 2008.
Mexico's oil reform

• On October 28, 2008, the Mexican Congress approved ten bills, six of which amended existing laws and the other four bills enacted new laws.

• The reforms adopted by these bills will improve, among other things, Pemex’s decision-making process and execution capabilities through:

  ➢ The appointment of new professional members to the Boards of Directors of Pemex and each one of its 4 subsidiary entities.
  ➢ The creation of 7 executive committees to support the Board of Directors of Pemex.
  ➢ The ability to issue *bonos ciudadanos* (Citizen Bonds) linked to Pemex’s performance.
  ➢ The implementation of a differentiated fiscal regime that considers field complexities.
Corporate Governance

6 Directors appointed by the federal government (the Minister of Energy is the Chairman)

4 professional Directors:
✓ Chair of key executive committees
✓ Power to defer decisions once with 3 votes
✓ 6 year staggered terms
✓ Possibility to be appointed for another 6 year term
✓ 5 Directors from the union

✓ Deep knowledge of the O&G industry
✓ Relevant experience as public servants
✓ Proved technical skills
✓ Strong academic credentials
Executive Committees

- The Chairman must be a Professional Director.
- Clear defined roles and responsibilities will enhance the decision making process and increase autonomy from the federal government.
- **Committees will improve current transparency, oversight and control mechanisms.**
- The 4 subsidiary entities must create Committees for Investment Strategy and Procurement.
Citizen Bonds

Main features

• The Ministry of Finance will establish the characteristics, terms and conditions, issuance and distribution mechanisms.
• Only available to Mexican individuals and financial institutions.
• A holding limit for each issuance of 0.1%.
• Returns will be linked to PEMEX’s performance.

Expected Benefits

• They will provide a market reference for decisions made by the company, increasing transparency and accountability.
• Mexicans will be involved in the evolution of PEMEX, aligning incentives of bondholders with PEMEX’s performance.
• The bonds represent a financing alternative.
• They will strengthen PEMEX’s balance sheet.
Other Bonds

Mexico

• The National Banking and Securities Commission authorized the issuance of bonds guaranteed by Pemex in accordance with the Stock Markets Law (Ley de Mercado de Valores). These bonds are listed in the Mexican Stock Exchange. All the relevant information of the issuer, specially the one related with risk factors, is contained in the prospectus and/or correspondent supplements, which are available in the website of the Bolsa Mexicana de Valores, S.A. de C.V. (www.bmv.com.mx).

United States

• Pemex has registered bond issues in the Securities and Exchange Commission (SEC). As a result Pemex has the obligation to file several forms; for example, the Form 20-F, on an annual basis. This registration permits PEMEX's securities to be purchased by any person or organization in the US markets.
Transparency and Accountability

- Since 2002 Pemex posts financial and operations data on its web page (http://www.ri.pemex.com/index.cfm)
- Pemex is audited by multiple entities: Secretaría de la Función Pública, external audit firm, Mexican Congress (Auditoría Superior de la Federación).
- Audit & Performance Evaluation Committee created in 2009, oversees financial and operational results.
- Public Information Federal Entity (IFAI): available information about Pemex and its operations increases public awareness.
- Citizen bonds will provide a benchmark to evaluate performance.
- The new regulatory framework clearly mandates the Board of Directors to create economic value to benefit Mexican society.
FISCAL REGIME

• Federal taxes levied from the Mexican oil and gas industry:
  ➢ VAT: general tax rate 16% (15% up to 2009)
  ➢ Special tax on gasoline and diesel
  ➢ Duties on Hydrocarbons
  ➢ Corporate tax
FISCAL REGIME

• **1994–2005**: The *Duty on hydrocarbons* (DSH) was levied on revenues from gross sales including the special tax (IEPS) on gasoline and diesel at a rate of 60.8%. Although there were other taxes, they were credited against DSH, and its rates adjusted so the sum be equal to the DSH, therefore Pemex ended up paying only DSH.

• **From 2006**: A special regime applies to upstream activities to tax the economic rent created by the exploitation of a natural resource; and to downstream operations are applied a corporate tax.

  Pemex Exploration and Production pays the *Ordinary Duty on Hydrocarbons* (DOSH). This duty is applied to gross revenue from crude oil and natural gas production less relatively standard deductions for exploration expense, capital investments, and operating costs. Cost caps are placed on costs deductible for DOSH. The applicable rate for this duty is 73.0% in 2010, and will be reduced to 71.5% by 2012.
FISCAL REGIME

• Pemex Exploration and Production pays other Duties with no impact on its cash outflow, because they are either credited against other taxes and duties, or deducted from the tax base of other duties: Duty on Hydrocarbons for the Stabilization Fund (for Federation’s revenue stabilization), Extraordinary Duty on Crude Oil Exports (for States’s revenue stabilization, and it is a windfall tax), and additional duties for specific purposes (technical energy research, and oil fiscal monitoring and auditing).

• On November 2008, the Mexican Congress approved a differentiated tax regime for oil fields located in the Chicontepec region and in deep waters, taking into account the very complex geological conditions in these fields, and therefore their higher exploration and exploitation costs. It has lower tax rates and higher costs caps. It is ring-fenced. This regime was modified for 2010.
## FISCAL REGIME

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<th>GENERAL REGIME</th>
<th>CHICONTEPEC AND DEEP WATER FIELDS</th>
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<td><strong>1. <em>Ordinary Duty on Hydrocarbons (DOSH)</em></strong>&lt;br&gt;• Applied to the value of extracted production of crude oil and natural gas less certain permitted deductions.&lt;br&gt;• The applicable rate for this duty is 73.0% in 2010 and will be reduced gradually to 71.5% in 2012 and thereafter.&lt;br&gt;• Deduction of costs must not exceed US$6.50 per barrel of crude oil equivalent (BOE) and US$2.70 per thousand cubic feet of non-associated natural gas.</td>
<td><strong>1. <em>Duty on Hydrocarbons Extraction</em></strong>&lt;br&gt;• Applied to the value of the crude oil and natural gas extracted. There are no deductions allowed.&lt;br&gt;• The applicable rate is 15.0%.</td>
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FISCAL REGIME

GENERAL REGIME

2. **Duty on Hydrocarbons for the Stabilization Fund**
   - Applied to the value of extracted crude oil and natural gas, when the weighted average export price of crude oil for a certain year exceeds US$22.00.
   - Rates between 1% and 10% are applied (10% above US$31.00 per barrel).

3. **Extraordinary Duty on Crude Oil Exports**
   - Applied to the value resulting from the product of: (i) the difference between the annual weighted average price of the Mexican barrel of crude oil and the budgeted crude oil price, times (ii) the annual export volume. The budgeted crude oil price for 2010 is US$59.00 per barrel.
   - A rate of 13.1% is applied.

CHICONTEPEC AND DEEP WATER FIELDS

2. **Special Duty on Hydrocarbons**
   - Applied to the value of extracted crude oil and natural gas less certain permitted deductions.
   - A 30.0% rate is applied if the field’s cumulative production is below 240 million BOE. Then a 36.0% rate is applied.

3. **Additional Duty on Hydrocarbons**
   - Applied to the value resulting from the product of: (i) the difference between the average price of the BOE produced in that field and US$60.00, times (ii) the annual field’s production of BOE.
   - A rate of 52% is applied.
FISCAL REGIME

• **Regime for Abandoned fields**: To encourage a higher rate of recovery in abandoned or declining fields.

• The regime for existing operations (DOSH) covers almost all current production of oil and natural gas. Current production from Chicontepec is only 20 mbd, but is expected to increase dramatically in the next several years. Deep water fields are in the early stages of exploration.

• Each duty or regime is ring-fenced, that is, they are not consolidated for tax purposes.

• Pemex Refining, Pemex Gas, Pemex Petrochemicals and the Pemex (holding) pay, each one, a Tax on Oil Returns. The tax base is determined by subtracting from gross revenues the allowed expenditures and costs (similar to the income corporate tax).
Oil Revenue Distribution

- Federal assignable taxes + Petroleum revenues (Pemex’s Duties)
  - 20% General Sharing Fund (Fondo General de Participaciones)
    - 20% Municipalities
    - 80% States

- Ordinary Duty on Hydrocarbons (DOSH).
  - 0.6% Oil Extraction Fund (Fondo de Extracción de Hidrocarburos)
    - 5 Oil States

States review the revenue data used to calculate Participaciones

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Appendix

Exploration and exploitation of crude oil and natural gas resources. The main objectives are to: 1) sustain current production levels; 2) increase the replacement rate of proved and total reserves and; 3) improve performance in terms of industrial security and environmental protection in a socially responsible way.

- Convert crude oil into refined products (gasoline, jet fuel, diesel, fuel oil, asphalts, lubricants, etc.).
- Distribute and commercialize these products throughout Mexico.
- Process wet gas onshore, in order to obtain dry natural gas, LPG and other natural gas liquids.
- Transport, distribute and commercialize natural gas and LPG throughout Mexico, as well as several petrochemical feedstocks.
- Manufacture petrochemicals products including methane derivatives, ethane derivatives, aromatics, propylene and its derivatives, as well as other products such as oxygen and nitrogen among others.