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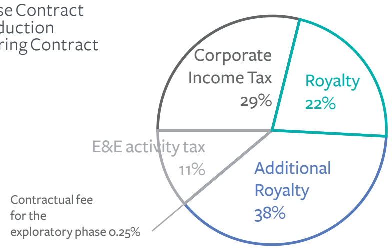
Economic balance protection in oil contracts

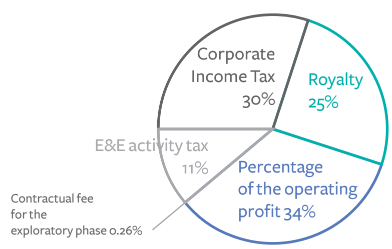
Mexican new government has emphasized its concerns regarding the government take in the awarded oil contracts. It is not clear if these worries will lead to an audit or some type of "adjustment" for the government take via legislation. In these times, understanding the risks and protection mechanisms available is of paramount importance to oil companies.

1.- FISCAL CONTRIBUTIONS AND THEIR STABILITY

The following graphs show the government take distribution by contribution type.

LC: License Contract
PSC: Production Sharing Contract





The fiscal elements in the blue areas (Royalty, Additional Royalty and Contractual fee for the exploratory phase) are frozen in Exhibit 3 of each LC and PSC. These terms, which reflect the Hydrocarbons Revenue Law in force at the time of contract awarding, cannot be changed unilaterally.

In contrast, the fiscal elements in the gray areas (corporate income tax and the exploration and extraction activity tax) are defined only in the Hydrocarbons Revenue Law. These two elements are unstable because they are subject to a change of legislation. Additionally, another source of fiscal instability is that Government could enact new contributions specific for the Hydrocarbons Industry.

Summary of tax elements stability

Stable

- Exploratory phase fee
- Royalty
- Additional royalty
- Adjustment mechanism
- Cost recovery
- Percentage of the operating profit

Unstable

- Corporate Income Tax
- Exploration and extraction activity tax
- *New contributions*

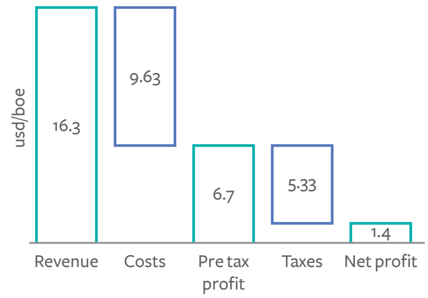
2.- RESTORING THE ECONOMIC BALANCE

Despite the unstable fiscal elements, contracts contain stabilization clauses that allow to restore the original project economic balance (revenues – costs) at the time of awarding, in case government increases or creates new contributions specific to the exploration and extraction activities. For PSC, the adjustment shall be made through cost recovery mechanisms whereas for LC it is contemplated an adjustment via the additional royalty rate.

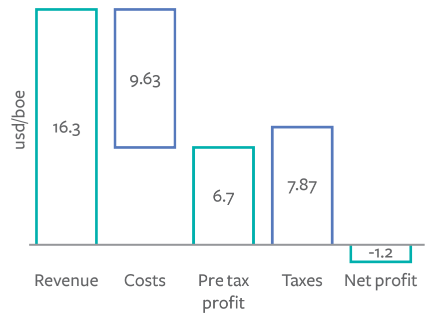
Contracts establish that the Ministry of Finance ("SHCP") shall apply these compensatory mechanisms, **but there is no definition about the applicable methodology, nor the resources to request for its application.** This lack of definition reinforces the contracts' instability of the fiscal regime leaving contractors exposed to higher risks. Even further, there is no certainty about the willingness of the SHCP to establish said mechanisms. In case of SHCP's reluctancy or establishing of an inadequate mechanism, contractors will have to go through an arbitration process.

Economic balance example

1 A project obtains a net profit of 1.4 dollars per barrel of oil equivalent (usd/boe) with the tax regime in force.



2 Due to an increase in taxes, the same project is affected resulting in net profits of -1.2 usd/boe.



3 SHCP should apply adjustments equivalent to 2.6 usd/boe to restore the original economic balance (net profits of 1.4 usd/boe) via adjustments to the additional royalty or cost recovery.

In Talanza we provide services of advance modelling for financial evaluation in the Mexican fiscal regime, developed by former officials in charge of the definition and evaluation of contracts' fiscal behavior. This has benefitted our clients' cashflow-related decision making processes.

ANALYSTS

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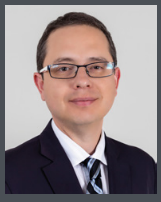

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Comprehensive energy regulatory consultancy given by former key officials that participated in the design and implementation of the energy reform.

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