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Fiscal regimes for the production of conventional and unconventional gas: Overview of Latin America

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Introduction

- In Latin America, ownership of the subsoil belongs to the State. Therefore, the State must grant either a license or concession or similar instrument for exploration and extraction activities. Albeit less common, they may seek to invite companies under services agreements or production sharing contracts. More typically then, under a license or concession companies are bound to pay a royalty on the gas production in favour to the State.

- Although there are some common trends in Latin America, such as government take, the fiscal regimes for the production of conventional and unconventional gas vary depending on the jurisdiction. Some countries, like Venezuela, have a unique treatment for gas production (only for non associated gas) and others, like Colombia, treat unconventional reservoirs differently from conventional production.

- The purpose of this presentation is to describe the most relevant fiscal aspects of gas exploration and production in Latin America.

The New kids on the block: Mexico

- On December 2013, Mexico amended its Federal Constitution to implement a new energy reform, in order to modernize the country.
- The energy reform ended the Mexican State's monopoly in the hydrocarbons sector and allowed private investment and participation in all areas of the hydrocarbons industry.

1. Royalties

- Each license contract, profit sharing contract and production sharing contract shall include a monthly payment in favor of the State on account of Royalties. The amount of the Royalties shall be determined, for each type of Hydrocarbon, by applying the relevant rate to the Contract Value of Natural Gas and the Contract Value of Condensates, as the case may be.

2. Government Take

i. License Contracts:

- Signing bonus,
- Exploratory phase fees,
- Royalties,
- % of the Production Value,
- Tax on E&P Activities.

ii. Production Sharing Contracts:

- Exploratory phase fees (cash),
- Royalties (in-kind),
- % of Production Profits,
- Tax on E&P Activities.

The New kids on the block: Mexico (cont.)

iii. Profit Sharing Contracts, to be paid in cash:

- Exploratory phase fees,
- Royalties,
- % of Operating Profits,
- Tax on E&P Activities.

iv. Service Contracts:

- Contractors will deliver all hydrocarbons produced to the State.
- Payments to Contractor shall only be made in cash as established in each service contract.
- Payments to the Contractor shall be made by the Mexican Oil Fund with the proceeds from the sale of the production derived from the corresponding service contract.
- Exploratory phase fees and royalties do not apply.
- There is no express provision in the Hydrocarbons Law allowing service contractors to "book" service contracts or economic interests there under.

<u>3. Taxes and Duties</u>

a. Tax on Hydrocarbons Exploration and Extraction Activities: Will be calculated on a monthly basis, applying the following fees per square kilometer comprised in the Contract Area:

- 1,500 pesos (approx. USD 100) during the exploration stage; and
- 6,000 pesos (approx. USD 402) during the extraction stage.

b. VAT

- VAT for allocation of production or profits is subject to 0% rate.

Stability in fiscal regimes: The Peruvian example

- The Organic Law of Hydrocarbons and related Peruvian tax regulations establish that the tax regime applicable to an oil and gas agreement is the one in force at the moment of its signature and it will remain unchanged during the term of such agreement.

- This tax stability is applicable to the contract activities, such as the exploration and production of hydrocarbons, but is not applicable to corporate tax applicable to the companies that entered into such license agreement.

- The stability in fiscal regimes ensures that no additional tax will be imposed upon the contract activities.

- No Ring Fencing: Contractors with more than one contract may offset the tax losses generated by one or more contracts against the profits resulting from other contracts or related activities.

Stability in fiscal regimes: The Peruvian example (cont.)

- Current Royalties:

  Contractors may choose 4 different methods to calculate the royalties to be paid for the exploitation of hydrocarbons:

  - ✓ R Factor method, where R equals X/Y (X: accumulated income, Y: accumulated expenditures).
  - ✓ Method of accumulated production by field with price adjustment. The royalty is subject to a price adjustment based on the average price per barrel applicable to the production of the field.
  - ✓ Method by production scale. This methodology establishes a percentage of royalty, starting at 5%, over certain scales of production for fiscalized natural gas liquids and fiscalized natural gas for each valuation period; and
  - ✓ Method by economic result, which consists of a fixed and a variable royalty. The fixed royalty is 5%. The variable royalty rate will be applicable in a range between 5% and 20%.

- Tariffs do not apply to the Exploration and Exploitation activities in Peru.
- No special terms apply to unconventional gas.

Unconventional resources: The Colombian bet

- Colombian hydrocarbons reserves are in decline and it is estimated that with the current rhythm of production the reserves will endure for an additional 6 years.
- The oil and gas industry has a huge impact on the Colombian trade balance and therefore the Colombian Hydrocarbon Agency (ANH) has established the necessity to increase the current hydrocarbons reserve
- The ANH issued Accord 004 of 2012 which establishes the main terms and conditions required to award hydrocarbons exploration and production areas, and Accord 003 of March 26, 2014, which builds upon Accord 004 of 2012 to include the terms and conditions required to award exploration and production contracts for unconventional resources.
- Colombia is one of the few countries with a specific regulation for the exploration and exploitation of unconventional gas.
- Incentives for the exploration of unconventional hydrocarbons in Colombia:
    - ✓ Royalties applicable to unconventional deposits will be equivalent to 60% of the participating percentage of the royalties equivalent to the exploitation of conventional light oil fields. The same benefit is also applicable for offshore gas fields at depths greater than 1,000 ft. For onshore gas fields and offshore gas fields at depths equal to or less than 1,000ft., the applicable royalties are equal to 80% of the royalties applied to onshore light oil fields.
    - ✓ For the payment of the fee for High Prices, the Base referential price (Po) for Liquid Hydrocarbons associated to Unconventional Oil Fields will of 81 USD/BI. For Exported natural gas Po starts at 8.15 USD/MMBTU and for Liquid Hydrocarbons Po starts at 35.22 USD/BI

Unconventional resources: The Colombian bet (cont.)

- Royalties:

  Royalties are calculated as a proportion -between 8% and 25%- of the daily gross production based on the monthly average production per field.

- Government take:
  - ✓ Subsoil Fees : For natural gas, this amount will be USD 0.01356 per every 1,000 CF.
  - ✓ Technology Transfer: This contribution is paid to the ANH for the professional and specialized formation related to the sector. The amount of the contribution will not exceed US$127,112.
  - ✓ High Prices Fee: Contractor shall pay to the ANH, a fee for “High Prices” (which is similar to windfall profits tax) on the production it owns, either in kind or in cash, at the ANH’s election. For Natural Gas, this Economic Right will be paid as of the fifth year after the start-up of the field’s production, for both conventional and unconventional fields or offshore, which is set forth in the approval resolution issued by the competent authority,
- Production Sharing:

  If the E&P Contract is a consequence of a bid process the ANH will receive the so-called X-Factor, which is the offered percentage of gross production after royalty by the contractor during the bidding process.

- Gas sold in Colombia is VAT(16%) excluded and Gas exported is VAT exempt.

Trends in Latin America, Government Take

- **Argentina**

Royalties	Tariffs	Taxes and duties
•12% of the wellhead value of hydrocarbons under an exploitation concession. This rate may be reduced to 5%. •15% of the value of hydrocarbons extracted under an exploration permit. •No special terms apply to unconventional gas. • Royalties may be treated as an immediate deduction for corporate income tax purposes.	• No tariffs are applied. However, tariffs are applied to the transportation of natural gas and oil through pipelines.	• No specific hydrocarbons tax. • VAT: In the case of Oil and Gas services rendered from abroad used in Argentina, 21% VAT shall be paid by the local recipient to the tax authorities within 10 working days following the date of the taxable event. • Must be rregistered as input VAT which may be used to offset output VAT (collected from its customers) during the month/s following that on which such payment was made.

Trends in Latin America, Government Take (cont.)

- **Brazil**

Royalties	Tariffs	Taxes and duties
• Royalties must be paid monthly, in local currency, as from the date of the start up of the commercial production of each field, in an amount equivalent to 10% of the gross revenue deriving from the sale of natural gas. • Considering the geological risks, production expectations, and other pertinent factors, the ANP may define the *reduction* of the royalties to a minimum of 5% of the production of natural gas.	• No tariffs are applied. • However, the Concession Contract establishes the obligation to pay a special participation similar to a royalty that applies only after a certain level of production, which depends on the location of the field. The rates range from 10 to 40%.	• No specific hydrocarbons tax. • There are several taxes and contributions, which are subject to a non-cumulative tax regime ("VAT-alike"), meaning that the amount of tax collected represents a tax credit that can be used to offset subsequent tax debts.

Trends in Latin America, Government Take (cont.)

- **<u>Venezuela</u>**

Royalties	Tariffs	Taxes and duties
•The royalty rate for associated gas is 30% of extracted hydrocarbons and may be reduced by the National Government to 20%. •The royalty rate for non associated gas is 20%, as an incentive to develop the upstream gas business	•No tariffs are applied.	•No specific additional tax applicable for gas. • <u>Special contribution</u>: other special contributions may be established in the respective exploitation licence equivalent to a specified percentage of the value gas that can range between 1.5% and 12.5% depending on the project. • <u>Surface contribution</u>: the exploitation license generally provides an annual payment determined on the basis of the respective production area's surface that ranges between 1/3 and 1 Tax Unit

Trends in Latin America Government Take (cont.)

- **Bolivia**

Royalties	Tariffs	Taxes and duties
•The royalty rate is 18% on the fiscalized production as follows: -Departmental royalty: 11% of the production for the benefit of the Department where the production is originated; -Compensatory National royalty: 1% of the national fiscalized production payable to two Departments. -Participation: 6% participation of the national fiscalized production in favor of the Bolivia's General National Treasury.	•No tariffs are applied.	•There is a Direct Tax on Hydrocarbons ("IDH") production at wellhead of 32%.

Conclusions

- In the last decade, Latin American countries have taken a more active role in the oil and gas industry.
- There is a trend in certain Latin American countries to open the investment barriers, allowing the entrance of foreign and private investors into their oil and gas markets. Others are blocking or excluding the more traditional forms of investment in this industry.
- Based on the United States experience on the development of unconventional resources, various Latin American countries are now aware of the potential of these resources. Notably, Mexico , Argentina and Colombia.