Oil Earnings and Fiscal Policy in Mexico

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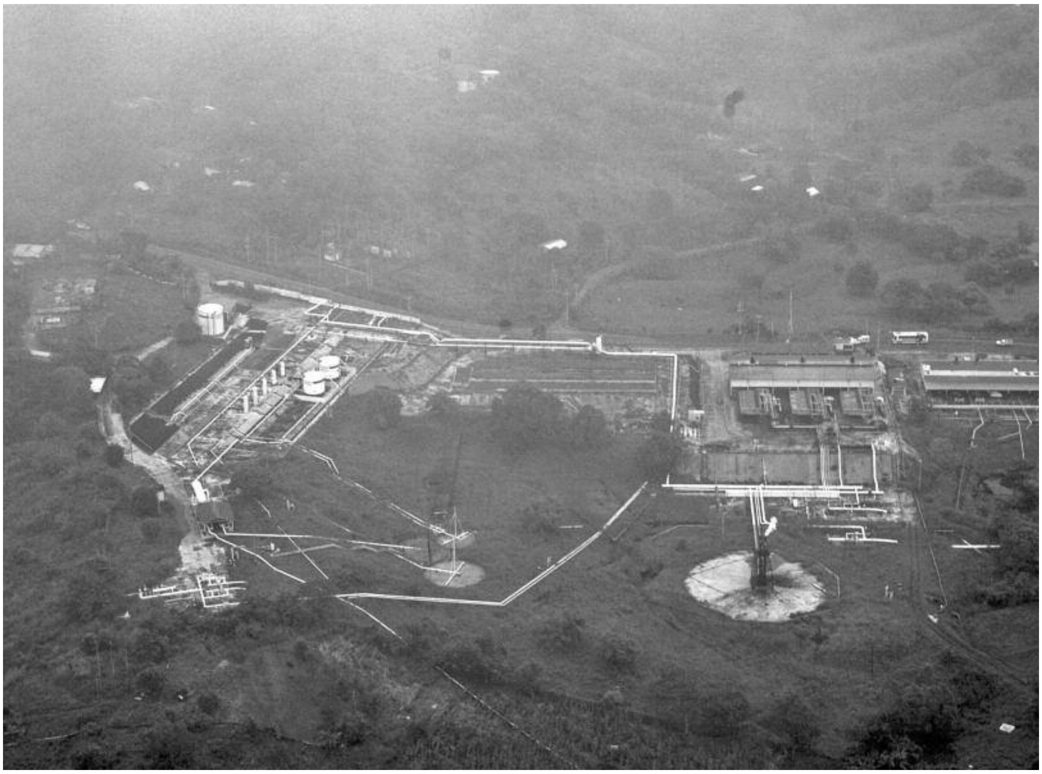
Isaac Aguilar/Reuters

In Mexico our oil industry's earnings have been used as a non-conflictive substitute for a progressive fiscal reform. By getting a significantly growing part of its income from oil, the Mexican state refused to make its fiscal policy re-distributive. Those who most benefit from this have been large corporations, which are taxed much less than the average similar company in Organization for Economic Cooperation and Development (OECD) countries. Not to mention speculative capital. What is more, the state changed the place that the Mexican Petroleum Company (Pemex) had in the regimen of accumulation. From being basically a secure provider of energy, Pemex became the main source of fiscal income. The Draconian fiscal regime to which Pemex has been subjected for many years has resulted in its decapitalization, a dramatic drop in our oil reserves, growing imports of petrochemicals and refined petroleum products, enormous debt and the resulting decrease in Pemex's capacity for productive investment.

To try to alleviate this situation somewhat, Congress approved a series of reforms to Chapter 12 of the Federal Duties Law, commonly known as "Pemex's New Fiscal Regime" (see

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TABLE 1
OIL AND NON-OIL REVENUES IN THE PUBLIC BUDGET (1998 - 2006)
(MILLIONS OF CURRENT PESOS)

ITEMS	2000	2001	2002	2003	2004	2005	2006
Net Budget Revenues[1]	1,179,918.9	1,271,646.3	1,387,500.4	1,600,589.8	1,771,314.2	1,948,172.9	1,973,500.0
Oil	434,742.7	386,579.1	410,037.7	592,665.7	720,745.6	760,545.6	783,338.7
Federal Government	326,159.9	283,055.1	260,005.7	416,888.8	529,973.6	574,967.2	522,974.7
Pemex[2]	108,582.8	103,524.0	150,032.0	175,776.9	190,772.0	185,578.4	260,364.0
% of oil revenues	36.8	30.4	29.6	37.0	40.7	39.0	39.7
Non-oil[3]	745,176.2	885,067.2	977,462.7	1,007,924.1	1,050,568.6	1,187,627.3	1,190,161.3
Federal Government	534,116.4	656,059.3	729,347.3	716,096.0	740,237.5	838,220.5	836,812.4
Taxes	465,896.3	567,681.7	616,062.3	619,758.0	633,399.9	787,670.7	785,366.5
Non-taxes	68,220.1	88,377.6	113,285.0	96,338.0	106,837.6	50,549.8	34,372.1
Bodies and Companies[4]	211,059.8	229,007.9	248,115.4	291,828.1	310,331.1	349,406.8	353,348.9
CFE	96,076.2	100,436.5	111,924.5	140,078.3	154,966.3	177,259.8	176,820.5
IMSS	85,598.2	95,462.1	100,682.9	115,819.4	122,684.2	132,664.0	141,176.0
ISSSTE	21,190.8	23,817.7	24,610.4	26,220.1	29,008.7	39,662.9	34,814.9
Others	8,194.6	9,291.6	10,897.6	9,710.3	3,671.9	-179.9	537.5

[1] Includes the tax on assets.
[2] By 2000 Pemex revenues included 7.9913 billion pesos in outside operations.
[3] Includes registration fees, ISAN, export taxes, ISCAS, luxury goods.
[4] Does not include federal government contributions to the ISSSTE.
Source: Finance Ministry Accounts 1980-2005 and 2006 Federal Revenue Law.

box). The aim was to take the first step toward restoring the state company's industrial vocation, alleviating somewhat a heavy tax burden that, with the regimen in effect until 2005, represented 105 percent of its net cash flow.

OIL SURPLUS: THE BATTLE FOR THE (NOT SO) MARGINAL PROFIT

Because of the constant rise in oil prices, particularly since 2004, one of the recurring themes in Mexico's economic and political debate has been the use of the so-called "oil surpluses," that is, the windfall tax monies from the oil industry. To deal with this issue, we should start by saying that, as can be seen in data from the Vicente Fox administration shown in Table 2, the difference between the real price of Mexican export-grade crude oil and the projections used for designing the budget has grown gradually from 2001 on, until it became very important in 2004.

By 2006, the average projected price was U.S.$36.50 a barrel. As these lines are being written, the price is over U.S.$52 a barrel. That is, there is a differential in price similar to that of 2005.[1]

Now, the "oil surpluses" have two components:

1. Greater income than expected, derived directly from higher oil prices than the estimate used for making fiscal calculations to design the earnings budget written out in the Federal Revenue Law.
2. Additional income as a result of an extraordinary duty that Pemex only pays the Finance Ministry when the price of Mexican export-grade crude mix surpasses the estimate in the Federal Revenue Law.

In the first case, surplus oil revenues are added to the income differentials (positive and negative) obtained through all the federal government's tax instruments with regard to what was expected for the year in question. Frequently, the collection of non-oil revenues is less than expected, and therefore greater oil revenues compensate for it. The result of this algebraic sum is generically referred to as "gross surplus income." From these "surpluses" are discounted what we could colloquially call "unforeseen" expenses.

The specification of the items included here may vary from year to year, but they are generally related to the increase in non-programmed spending (financial costs or debt from previous fiscal years), in the cost of fuel used by the Federal Electricity Commission, adjustments to maintain the goal of a balanced budget or even the damages caused by natural disasters. The distribution of the remaining amount (net surplus income) is also decided annually by the Chamber of Deputies in the respective Expenditures Budget.

In 2004, gross surplus revenues came to 55.7096 billion pesos. Once the increase in the non-programmed expenditures had been discounted and an adjustment had been made to maintain a balanced budget, the net surplus was 46.5954 billion pesos. According to the 2004 Federal Expenditures Budget, 25 percent of this money was earmarked for the Oil Revenue Stabilization Fund; 25 percent went to pay off debt; and 50 percent went to the states. By 2005, gross surplus rose to 62.1562 billion pesos and net surplus was 44.6107 billion pesos. Of the gross surplus, 8.294 billion pesos were used to repair the damage from hurricanes that battered the country. In that year, 25 percent of the net surpluses went to the Oil Revenue Stabilization Fund, 25 percent to pay off debt and 50 percent for infrastructure in the Mexican Oil Company. I will explain later the reasons for this change in the distribution of the net surplus.

Let us look now at the second component of oil surpluses. As I already pointed out, when the price of Mexican export-grade oil goes over what was estimated in the Revenue Law, Pemex must pay an additional tax. In the oil fiscal regime in effect until 2005, this extraordinary payment was made by means of the Surplus Yield Payment (ARE), which was calculated using a 39.2 percent rate on the surplus yield of exports, defined as the difference between the average value and the estimated value of a barrel of Mexican export-grade crude, multiplied by the total volume of exports. Until 2003, this payment went directly into federal coffers. In 2004, according to a proposal from the Party of the Democratic Revolution caucus, 100 percent of the ARE was returned to Pemex in the form of the Payment for Infrastructure fund (AOI), which meant that Pemex received capital from the federal government to the tune of 34.025 billion pesos. By 2005, the states received half of the ARE, that is, 19.6 percent of the surplus from exports of crude. With the change in Pemex's fiscal regimen, the "reduced" version of the ARE (6.5 percent of the export surplus) was maintained, unduly so because it had never been considered when making the financial projections of the new fiscal regimen (see table 3)

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THE DISCRETE CHARM OF DISCRETION

If anything is characteristic of oil surpluses it is the great power that those who control them have to distribute them at their discretion. In the first place is the Finance Ministry, which has an enormous comparative advantage in terms of economic and financial information, administrative control and political weight, allowing it to manipulate the amounts, rhythms of payment and budgetary assignation

TABLE 2
DIFFERENCE BETWEEN THE REAL AND ESTIMATED PRICE OF MEXICAN EXPORT-GRADE OIL
(DOLLARS/BARREL)

YEAR	ESTIMATED PRICE	REAL PRICE	DIFFERENCE
2001	18.00	18.70	0.70
2002	17.00	21.56	4.56
2003	17.00	24.80	7.80
2004	20.00	31.05	11.05
2005	27.00	42.69	15.69

Source: Developed by the author based on the general criteria of economic policy (Finance Ministry), the Federal Revenue Law and oil indicators (Pemex).

of these resources (its instinctive reflex is to put forward financial and macroeconomic variables). For state governors the only condition established in the Federal Expenditures Budget is that they use the monies for infrastructure. However, this is not really a practical limitation of any kind, since in general, in the best of cases, local congresses are informed of what the surpluses were used for only after the monies have been spent. This is the reason that both the Finance Ministry and the National Conference of Governors (Conago) insist on promoting mechanisms that foster an absurdly low estimate of Mexican export-grade crude when designing the budget.

Since it has neither budgetary nor entrepreneurial autonomy, Pemex's hands are tied in this dispute over the surplus: with the 2006 budget proposed by the federal executive and passed by the majority of the Chamber of Deputies and with the respective changes in the AREs, our oil company lost a large part of what had been earned in 2004 and 2005. What topped it off was when the Finance Ministry managed to use the 25 billion pesos of tax relief provided for in Pemex's new regimen to increase the primary surplus annually imposed on the company in order to make national figures jibe instead of investing them.

Even though from year to year, oil surpluses appear to be strictly regulated, the reality is that their delivery involves a real test of strength among the different actors of the Mexican state. What happened in 2004 and its consequences illustrate this very well. In that first year of copious extraordinary oil revenues, the Finance Ministry bargained down the size of the payments to the states. The main point of contention was the amount considered to calculate the increase in the non-programmed spending, which should have been discounted from the total gross surplus. In particular, suspicions arose because of the estimates of previous fiscal debt, whose impact on the budget should have been calculated way under the 18.2267 billion pesos that the Finance Ministry recognized. Finally, after several meetings, the Conago came to an agreement with the Finance Ministry about amounts and a payment schedule.

Table 3
Surplus Revenues Received by the States (2004 and 2005)
(millions of pesos)

State	2004 (50% of net surplus)	2005 (50% of the ARE)
Aguascalientes	243.1	256.0
Baja California	650.8	632.1
Baja California Sur	160.9	155.1
Campeche	295.0	226.1
Coahuila	547.3	505.8
Colima	186.2	165.6
Chiapas	989.8	976.7
Chihuahua	687.2	651.0
Durango	319.3	287.6
Federal District	2,459.3	2,330.2
Guanajuato	899.4	836.7
Guerrero	551.6	519.3
Hidalgo	434.5	399.6
Jalisco	1,347.2	1,392.8
Michoacán	655.5	628.9
Morelos	352.0	331.1
Nayarit	239.0	216.7
Nuevo León	1,026.7	969.8
Oaxaca	597.4	550.8
Puebla	946.1	894.6
Querétaro	419.3	382.5
Quintana Roo	245.9	241.0
San Luis Potosí	451.0	411.0
Sinaloa	601.8	564.9
Sonora	605.9	556.4
State of México	2,995.9	2,790.3
Tabasco	1,256.5	1,283.4
Tamaulipas	641.2	626.2
Tlaxcala	246.8	230.2
Veracruz	1,502.4	1,368.1
Yucatán	356.9	342.0
Zacatecas	289.0	264.6
Total	23,201.0	21,986.4

Source: Developed by the author using Finance Ministry quarterly reports on the economy, public finances and the debt.

This conflict with the Finance Ministry taught the governors something: it was better to receive surplus revenues through the Surplus Yield Payment (ARE) because it is calculated using public information, like the average price and volume of Mexican oil exports. For this reason, the Conago investigated and found out that for fiscal year 2005, the surplus earmarked for the states was 50 percent of the ARE, leaving Pemex the other half and half of the net surplus. This made the company's position fragile since its ability to maneuver politically cannot be compared with the Conago's.

A NEW ATTACK ON INVESTMENT IN THE OIL SECTOR

The recent approval of the Budget and Fiscal Responsibility Law (LPRH) is a sharp blow against the urgent need to invest in infrastructure and oil exploration. It restricts the scope and potential of the Pemex's New Fiscal Regimen; it legitimizes the Conago's voracious quest to amass oil surpluses (with the corresponding economic ineffectiveness that this implies); and it confirms Congress's refusal to make the most minimal analysis of the international oil market.

Article 19 of the law confuses —to the point of making them equivalent— the current circumstances of the international oil market (exemplified by a scenario of high prices for crude at least for the medium term) with the conditions of national oil infrastructure, which is very backward and severely deteriorated. Seemingly, whoever wrote this article was thinking of Norway Statoil and not Pemex. It states that surplus revenues

> resulting from the Federal Revenue Law, other than those mentioned in Subsection II and III and the following article [which refer to previously earmarked revenues and revenues of the states, respectively] must be used in the first place to compensate for the increase in non-programmed expenditures versus what was budgeted for payments; the financial cost derived from changes in the interest rate or the exchange rate; debts from previous fiscal years to cover the difference between the amount approved in the Federal Expenditures Budget and the limit stipulated in Article 54, Paragraph 4 of this law; and the relief in the cases of natural disasters when the Disaster Fund referred to in Article 37 of this law is insufficient.

The surpluses defined here must also be earmarked for the Federal Electricity Commission "to cover increases in fuel costs *vis-à-vis* the estimates approved in the Federal Revenue Law and its own budget."

Subsection IV of the same article stipulates that the remainder will be distributed in the following way:

a) 25 percent to the State Governments Revenue Stabilization Fund;
b) 25 percent to the Pemex Infrastructure Investment Stabilization Fund;
c) 40 percent to the Oil Revenue Stabilization Fund;
d) 10 percent to programs and projects for investment in infrastructure and equipment for the state governments. These resources will be earmarked for the states according to the proportional structure derived from the distribution of the General Apportionment Fund reported in the most recent Public Accounts.

In addition, the same subsection of the law stipulates that surplus income

> will be earmarked for the funds specified in this clause until such a time as an appropriate reserve has been reached that will make it possible to successfully deal with a drop in the federal revenues distributed between the federal and local governments or in the federal government and Pemex's oil revenues. The amount of these reserves in pesos will equal the product of the estimated liquid oil and gas production platform for the year, expressed in barrels, by a factor of 1.875 for the case of a) and d), and 3.75 in the case of c), in all cases by the exchange rate of the U.S. dollar to the peso expected for the fiscal period. In the case of the surplus revenues for the fund referred to in b) of this sub-

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> section, these resources will be transferred annually to Pemex so it can constitute its reserve.

The constitution of the funds referred to in Subsection IV implies, on the one hand, that resources derived from the surplus revenues will continue to be sent to the Oil Revenue Stabilization Fund, given that Pemex's new fiscal regimen establishes the Oil and Gas Duty for the Oil Revenue Stabilization Fund. In other words, the fund will be constituted according to the Federal Law on Government Duties based on a duty created expressly for the purpose; therefore, there is no need to continue to feed it by other means, particularly if we consider that, in accordance with this stipulation, the fund begins to be generated starting from when Mexican export-grade crude oil has a cost of U.S.$22/barrel, a price quite a bit lower than that of recent months.

In addition, the way the funds established in the same clause are constituted implies freezing the use of large sums of money, as though neither Pemex nor the states had any urgent need of infrastructure. For example, considering the expectations established in economic policy's general criteria, the Oil Revenue Stabilization Fund could not be touched before accumulating 54 billion pesos; and the funds for infrastructure for the states and for Pemex itself could not be touched before they accumulated 27 billion pesos. That is, we are talking about freezing the use of more than 100 billion pesos. Subsection V of Article 19 states that:

> Once the reserve referred to in the previous subsection of the law reach the stipulated amount, the surplus income referred to in Subsection IV of this article will be distributed in the following way:
>
> a) 25 percent to the infrastructure investment programs and projects established in the Federal Expenditures Budget, with preference for spending on priorities in the states;
> b) 25 percent to programs and projects for investment in infrastructure and equipment for the state governments. These resources will be earmarked for the states according to the proportional structure derived from the distribution of the General Apportionment Fund reported in the most recent Public Accounts.
> c) 25 percent to Pemex programs and projects for investment in infrastructure;
> d) 25 percent for the Pension Restructuring Support Fund.

Seemingly, the idea is to charge Pemex for the new fiscal regimen by eroding its alternative sources of revenues. The Conago championed the no vote on the reforms to the Federal Law on Government Duties, and, at the time of this writing, it will be the state governments (who already receive the Extraordinary Duty for Oil Exports) who benefit most by receiving 50 percent of these surpluses that they do not currently receive. In this case, it seems to this author that Pemex should have retained the percentage contained in the distribution of equivalent surpluses stipulated in the Federal Expenditures Budget. In contrast, an idea I think is appropriate is to use oil surpluses to solve the financial problems of the social security system.

As we have seen, as long as Pemex does not have certain budgetary and entrepreneurial autonomy, the use of high oil income will continue to be decided in political spaces where concerns about the company's technical, financial and operational health are relegated to the back burner. In order to strengthen the company, taking advantage of this new stage of high prices for Mexican crude, I think that at least Pemex's Charter should be changed to establish the basis for reunifying it into a single body. It would also be a good idea to analyze the possibility of incorporating in the Sectoral Planning System the fundamental traits of the French category of the "plan contract" and Pemex's obligation to strengthen its strategic planning and operate according to the best practices of the oil industry in order to achieve maximum oil recovery.[2] These elements, together with updating the Oil Works Regulation, would allow for long-term prospects for oil exploitation in our country. VM

Notes

[1] The price want up to more than U.S.$70 per barrel because of the Israeli-Hizbullah conflict.

[2] The concept of "plan contract" is used by the French government to establish medium-term objectives for public companies, at the same time that it commits itself to provide them with the resources they need to meet them.

PEMEX'S NEW FISCAL REGIMEN

Under the previous fiscal regimen, Pemex gave the Finance Ministry 60.8 percent of all its revenues. The fundamental change that the new arrangement brings about is the introduction of a differentiation between the fiscal framework for extraction and industrial activities. This is explained as follows for the different companies that make up Pemex:

a) Pemex-Exploration and Production (PEP) is mandated to pay the following duties:

- *Ordinary Gas and Oil Duty (DOH).* This is the fundamental instrument for transferring oil revenues to the state. The taxable amount is calculated by deducing the following from PEP's total revenues:
  1. what is paid in duties and contributions explained in detail later;
  2. investment in exploration, secondary recovery and non-capitalized maintenance, as well as a percentage that varies between 5 percent and 16.7 percent of the investment made in other substantial activities of the company;
  3. production costs of up to a maximum of U.S.$6.50 per barrel of crude and U.S.$2.70 per thousand cubic feet of natural gas. These ceilings will be reviewed annually after the fifth year that the new fiscal regimen has been in effect.

A 79-percent tax will be applied to the resulting taxable amount.

- *Gas and Oil Duty for the Oil Revenue Stabilization Fund.* PEP will pay this duty when the price of export oil exceeds U.S.$22 a barrel, according to a rate that increases one percentage point for every dollar that the price exceeds the U.S.$22 "floor", to a maximum of 10 percent, calculated on the basis of the total value of oil production. Given that the 2006 Revenue Law stipulates an estimated price of U.S.$36.50 and that, according to the second transitory article of Pemex's new fiscal regimen, the amount of this duty until that 2006 estimate can be budgeted, the 2006 Federal Expenditures Budget includes about 53 billion pesos that had not originally been considered.

- *Extraordinary Duty on Crude Oil Exports (DEEP).* PEP will pay this duty when the price of the Mexican export mix exceeds the estimate in the Revenue Law. It will be calculated using a 13.1 percent rate, applied to the difference between the price and the estimate of exported crude oil. The entire amount of this duty will be paid to the State Government Revenue Stabilization Fund.

- *Payments.* In addition, PEP will make a payment equal to 0.05 percent of the value of all oil and gas pumped to support the Mexican Oil Institute's scientific and technological research, and another 0.003 percent of the same amount to contribute to supervisory activities of the Federal Auditor's Office.

- *Surplus Yield Payment (ARE).* In principle, this payment should have disappeared with Pemex's new fiscal regimen; however, it was maintained as a concession to the governors who pressured through the National Governors Conference (Conago) up until the last moment against passing the bill. The difference is that this payment will be 6.5 percent of export surpluses, which, added to the 13.1 percent of the DEEP, makes for an equivalent of 19.6 percent, which the states received in 2005.

b) Pemex's other subsidiaries, Pemex-Refining, Pemex-Petrochemicals and Pemex-Gas and Basic Petrochemicals will be subject to the 35 percent Tax on Oil Yields applied to their profits. While today these companies are in the red, by 2006, it is expected that Pemex will be paying this tax amounting to almost 5 billion pesos. Thus, the industrial activity that is not now generating fiscal revenues will begin to do so little by little (see table 1).