JUNE-JULY 2015

FISCAL NOTES

ALSO INSIDE THIS ISSUE:

Franchise Tax Lawsuit Could Cost Texas $1.5 Billion a Year

by Josh Haney

To argue about what a movie really *is* sounds like the stuff of art-house reviews and film school seminars. But the Texas Comptroller's office has spent three years arguing in court about the appropriate way in which to think about the movie-watching experience. The matters at stake are monetary rather than aesthetic — and could have a multi-billion-dollar impact on the state's finances.

This court case, *American Multi-Cinema (AMC) Inc. v. Hegar et al*, centers on the question of whether movies shown in a theater count as the sale of "tangible personal property" (TPP), which must be property "perceptible to the senses" under Texas law. Traditionally, in implementing the law, the Comptroller has considered movie theaters to be providing a service rather than any sort of tangible product.

The designation matters because, under Texas' primary business tax, the franchise or "margins" tax, businesses that own and sell TPP can deduct the direct costs associated with its acquisition or production in calculating their franchise tax through a deduction called Cost of Goods Sold (COGS). The law clearly states that TPP does *not* include services or intangible goods such as trademarks, copyrights and licenses. Therefore, businesses that only sell services or intangible property cannot include production and other costs in their COGS deduction.

Or at least that was the presumption until recently.

In late April 2015, a panel of judges from Texas' Third Court of Appeals made a surprisingly broad ruling that the movie theater chain AMC actually produces and

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Traditionally, the Comptroller has considered movie theaters to be providing a service rather than any sort of tangible product.

GOODS AND PROPERTY

The AMC litigation involves two key legal concepts.

COST OF GOODS SOLD: a deduction allowed under Texas' franchise tax that generally includes costs related to the acquisition and production of goods for sale. For a restaurant, COGS could include costs that go into the production of food, such as kitchen staff wages and the costs of ingredients, ovens and other cooking equipment. It was not considered to include costs associated with selling or consuming the items, such as the wages paid to wait staff or the costs of cash registers and restaurant décor.

TANGIBLE PERSONAL PROPERTY: personal property that can be seen, weighed, measured, felt or touched or that is perceptible to the senses in any other manner. In a restaurant, this would refer to the food and drink sold to and consumed by customers. Additional Texas statutes have expanded the definition to include products such as DVDs and computer programs.

A Message from the Comptroller

When you buy a ticket for the movies, what are you really buying? Is it a service the movie theater performs for you in exchange for your money? Or is the experience of watching the movie in itself a "product" that you've bought?

If this seems like an overly theoretical question — or a meaningless one — it also threatens to have very real consequences for our state's finances.

In the June-July *Fiscal Notes*, we discuss one of the most significant recent legal challenges facing our revenue system, and a court decision that could, if upheld, create an annual $1.5 billion hole in our franchise tax collections.

We also look at the ongoing deregulation of Mexico's energy resources. Mexico nationalized its oil and gas production way back in 1938, but now is opening many of its fields to private development. It's a move that may revitalize the nation's energy production — and offer new opportunities to Texas' own energy giants.

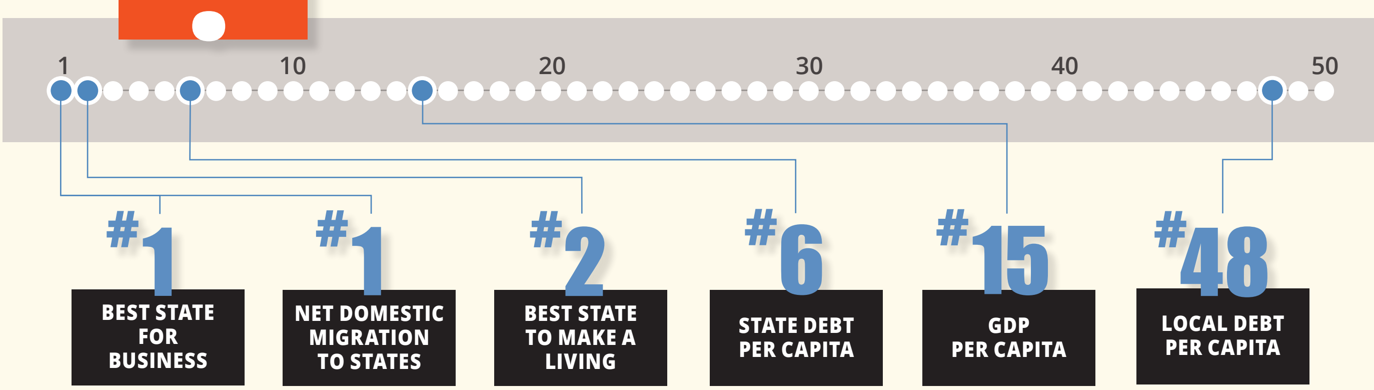
And we continue to follow other important developments in the Texas economy. In this issue, we examine the impressive growth of the state's automotive manufacturing industry, the nation's sixth largest by employment, and the training and educational opportunities we'll need to ensure that it keeps thriving.

I hope you enjoy this issue of the all-new *Fiscal Notes*.

GLENN HEGAR
Texas Comptroller of Public Accounts

THE FIFTY STATE SCORECARD

Visit our online scorecard tool to see how Texas compares on issues such as debt, taxes and business environment. Get in-depth descriptions, key takeaways and additional data for each ranking.



As proud Texans, our policymakers and taxpayers want to know how the Lone Star State stacks up when compared to other states. How's the economy? What about taxes? Debt? Personal wages? These facts are more than mere bragging rights — they can have critical implications for our future.

SEE MORE COMPARISONS

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sells TPP within the statutory definition when it exhibits a movie. If the act of showing a movie in a theater constitutes the sale of a tangible good under this definition, because the movie is perceptible to the eye and ear, then virtually *anything* "perceptible to the senses" may qualify as TPP, effectively rendering the term meaningless.

The real-world consequences of this decision become apparent when considering how it could affect the tax liability of service businesses, a fast-growing part of the state's economy. For example, a domestic worker cleaning a house is currently considered a service provider under Texas law. Under the Court of Appeals' interpretation, however, a clean house could be considered "perceptible," so housecleaning might be classified as TPP. That distinction would allow all cleaning products and equipment purchased by a cleaning service to qualify as COGS.

Multiply that small example by all the services provided and intangible products sold in Texas, and the cumulative fiscal impact due to the expanded COGS deduction could rise to *$1.5 billion each year* — about 26 percent of the franchise tax's total collections. Furthermore, businesses can amend their tax returns for up to four years back under Texas law. Refunds as a result of these amendments could reach up to *$6 billion*.

DOES SHOWING A MOVIE CREATE "TANGIBLE" PERSONAL PROPERTY?

The definition of TPP in the franchise tax portion of the Texas Tax Code has evolved since the margins tax — the current form of the state's franchise tax — became effective in 2008.

That portion of the code initially defines TPP as "personal property that can be *seen, weighed, measured, felt or touched, or that is perceptible to the senses in any other manner*." [Emphasis added.] Any grocery store contains examples of TPP: a package of paper towels, a carton of eggs or a bouquet of flowers.

Legislation passed in 2007, however, tweaked the TPP definition to include "films … and other similar property … without regard to the means or methods of distribution or the medium in which the property is embodied …." At the time, this was understood to bring the costs involved in the creation of media content such as movies, TV shows or music under the umbrella of TPP.

During the 2013 legislative session, the margins tax was revised significantly. Tucked in this package of reforms was a new statutory provision specifically crafted to address AMC's wish to claim a COGS deduction for exhibiting a film. This provision allows movie theaters to include the cost of "acquisition, production, *exhibition* or use of a film or motion picture, including expenses for the right to use the film or motion picture" in the COGS deduction.

This narrowly drawn provision was specifically intended for movie theaters, for inclusion in tax returns beginning in 2014. At the time, the Comptroller's office estimated that the new law would cost the state about $3 million in lost revenue each year. This estimate, however, could not have anticipated the much larger potential losses from the Third Court of Appeals' recent decision, which interprets terms not limited to movie theaters.

The following graphic shows the three statutory provisions related to TPP that are central to the AMC case, as well as their estimated potential impact to the state budget.

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Under the Court of Appeals' interpretation, a clean house could be considered "perceptible," so housecleaning might be classified as tangible personal property.

IF WATCHING A MOVIE IN A THEATER QUALIFIES AS A SALE OF TPP UNDER THIS DEFINITION…

ESTIMATED FISCAL IMPACT

HIGHEST

171.1012(a)(3)(A)(i):

"perceptible to senses"

ESTIMATED IMPACT:

Could allow many service providers and others to include certain costs in COGS. Cost to state estimated at $1.5 billion a year as well as a potential $6 billion in refunds.

171.1012(a)(3)(A)(ii):

"films and other similar property … without regard to medium"

ESTIMATED IMPACT:

Could allow other media/entertainment companies to include certain costs in COGS deduction. No estimated fiscal impact available.

LOWEST

171.1012(t):

for movie theaters, COGS can include exhibition costs

ESTIMATED IMPACT:

Restricted to movie theaters. Cost to state estimated at $3 million a year.

Note: references are to the Texas Tax Code.

Franchise Tax Lawsuit Could Cost Texas $1.5 Billion a Year CONTINUED FROM PAGE 3

While the 2013 law allowed AMC to include the cost of exhibiting films in its COGS deduction (as of September 1, 2013), the company sought to maximize its tax refund by convincing the courts that the movie experience it offers qualifies as a product under the most basic TPP definition. In other words, AMC maintains it is not a movie exhibition *service*, but instead defines its business as the production and sale of a tangible personal product that is "perceptible to the senses." Essentially, the company needed to convince the courts that seeing a movie in a theater is more akin to buying a chair than purchasing a service.

To do so, AMC put extensive effort into describing the process required to turn a movie into the sensory experience viewers enjoy in a theater.

It wasn't simply showing a movie, the company argued, but instead was putting extensive work and expense into producing a product — projectors must be purchased, maintained and serviced, sound levels need equalizing and so forth. Even the design and construction of the theater space itself, down to the upholstery on the seats, is a cost contributing to the movie-watching experience, according to this logic.

"When each of these integrated elements functions correctly, the result is 'the premium motion picture sight and sound experience,'" wrote AMC in its initial brief. In short, the final "product" AMC sells is the total sensory experience one receives in a movie theater, which exists only in the minds of its patrons.

Essentially, AMC needed to convince the courts that seeing a movie in a theater is more akin to buying a chair than purchasing a service.

IS AN "EXPERIENCE" PROPERTY?

The Comptroller's office took issue with this conflating of TPP and "experience." AMC's customers do not leave with a personal copy of the movie. In fact, distributing a physical copy of the film would violate AMC's agreement with movie production companies. Instead, the only "personal property" customers leave with are memories, which the Comptroller's office argued are *not* tangible products under any previous interpretation and are highly unlikely to be what the Legislature intended to include in its various definitions of TPP.

"AMC characterizes what it sells when it exhibits movies as experiences and memories," the Comptroller's office wrote in its brief. "But even if the Court accepts this characterization, experiences and memories are not property, but are instead part of human life. They are not subject to ownership. They cannot be bought or sold. There is no precedent describing experiences and memories as property."

The Comptroller's office asserted that this interpretation of TPP was directly at odds with an entire body of media and entertainment law, as well as the historical interpretation of TPP in other areas of Texas tax law, such as those pertaining to the sales and use tax.

HOW DOES THE FRANCHISE TAX WORK?

THE FRANCHISE TAX IS TEXAS' PRIMARY BUSINESS TAX, USUALLY NETTING THE STATE $4 BILLION TO $5 BILLION ANNUALLY, OR ABOUT 9 PERCENT OF ITS TOTAL TAX COLLECTIONS.

THE TEXAS FRANCHISE TAX → IS BASED ON → A BUSINESS' "TAXABLE MARGIN" → DEFINED AS → ITS TOTAL ANNUAL REVENUE → MINUS → THE LARGEST OF 4 POTENTIAL DEDUCTIONS

- TOTAL WAGES, CASH COMPENSATION AND BENEFITS;
- 30 PERCENT OF TOTAL REVENUE;
- $1 MILLION; OR
- COST OF GOODS SOLD (COGS), THE DEDUCTION AT THE CENTER OF THE AMC CASE.

BUSINESSES THEN MULTIPLY THIS AMOUNT BY THE PORTION OF THEIR TOTAL GROSS RECEIPTS (WHICH IS IDENTICAL TO TOTAL REVENUE FOR MOST BUSINESSES) EARNED IN TEXAS.

FRANCHISE TAX RATES FOR 2015:

- 0.475 PERCENT → QUALIFYING RETAILERS & WHOLESALERS
- 0.95 PERCENT → MOST OTHER ENTITIES
- 0.575 PERCENT → BUSINESSES WITH $10 MILLION OR LESS IN TOTAL REVENUE

THIS IS CALLED THE "EZ RATE," AND THESE BUSINESSES FOREGO CERTAIN OTHER DEDUCTIONS.

The Texas sales tax and the concept of TPP were both introduced into Texas law in 1961 (the sales and franchise taxes use the same initial definition of TPP). Since its introduction, TPP has never before been interpreted as encompassing services. In fact, the Texas Legislature specifically mentioned "amusement services," such as movie theaters and concert halls, in a sales tax provision listing taxable services added to the law in 1984. (The sales and use tax applies to sales of taxable services as well as sales of TPP.)

An additional provision related to taxable services includes the "repair, remodeling, maintenance, and restoration of tangible personal property." How could one maintain or repair a "product" that is only assembled inside an individual's mind? Clearly, the Comptroller's office argued, the Legislature intended TPP to describe concrete, corporeal objects.

While AMC focused on defining the movie-watching experience itself as the "product," an additional argument from the Comptroller's office focused on what AMC actually sells — movie tickets. Tickets are, the Comptroller proposed, nothing more than a license to view a movie at a particular time and place, and licenses generally are considered to be intangible goods.

AMC responded by insisting that its product is the *experience*, not the ticket, arguing that its customers are not merely purchasing the right to sit in a darkened theater. Instead, its patrons are purchasing a tangible product, namely the sights and sounds of the film, which are "perceptible to the senses" as required under Texas law.

The Comptroller's office then proposed that the court find AMC to be a movie-exhibition company that performs a service, rather than produces a product. It relied on a 2013 Third Court of Appeals decision that defined services, following Webster's Dictionary, as "useful labor that does not produce a tangible commodity," noting that "railroads, telephone companies and physicians perform services although they produce no goods."

COURT SIDES WITH AMC

The Third Court of Appeals grounded its AMC decision in the fact that the statutory definition of TPP includes, among other things, the requirement that the property be "perceptible to the senses." The court agreed with the characterization that AMC's exhibition of films was "visible to the sight and … perceptible to sound" and echoed its claim that its films were "creative content that is consumed."

The Comptroller's office argued that the Legislature intended TPP to describe concrete, corporeal objects.

Depending upon the court's decision on rehearing, the AMC case is likely to be appealed to the Texas Supreme Court. A decision at that level may be years away.

The court also addressed the lack of a physical product by noting that Texas tax law does not have a "take-home requirement," meaning that TPP can be sold without the purchaser gaining ownership of any physical matter.

The court further bolstered its definition of movie watching as TPP by pointing to the 2007 addition to the definition, as embodied in Texas Tax Code 171.1012(a)(3)(A)(ii):

> … *films*, sound recordings, videotapes, live and prerecorded television and radio programs, books, and other similar property embodying words, ideas, concepts, images, or sound, *without regard to the means or methods of distribution or the medium in which the property is embodied*, for which, as costs are incurred in producing the property, it is intended or is reasonably likely that any medium in which the property is embodied will be mass-distributed by the creator or any one or more third parties in a form that is not substantially altered.

The court then cited an AMC witness who suggested that the movie screen itself is a "medium" in which the property is embodied (despite the fact that the film as embodied on a theater screen is not intended to be "mass-distributed" in any form).

This is unlikely to be the last word on the AMC case. The Comptroller's office intends to request a rehearing.

Depending upon the court's decision on rehearing, the AMC case is likely to be appealed to the Texas Supreme Court. A decision at that level may be years away. **FN**

Note: The legal arguments described in this article have been summarized for clarity and accessibility. To understand all of the issues involved in this case, readers may wish to review briefs and other materials on file with the Third Court of Appeals at **www. txcourts.gov**; search on case 03-14-00397-cv.

Texas Automotive Manufacturing Growing, Going Fast

by Lauren Mulverhill

TRANSPORTATION INDUSTRY IS DRIVEN TO SUCCEED

The wheels started coming off Detroit's once unstoppable automotive industry some four decades ago, and the trend only accelerated in recent years. More than half of its jobs vanished between the late 1990s and 2012.

But while Michigan's auto plants were being shuttered, Texas was opening doors. The state's positive business environment has encouraged several major manufacturers of autos, parts, engines and commercial vehicles to put down roots in our state, including Peterbilt, GM, Toyota and Caterpillar.

Today, Texas ranks sixth nationally in automotive manufacturing employment, and second in the value of its exports of transportation equipment (motor vehicles, vehicle bodies, trailers and parts).

LEON HANDT

ASSISTANT GENERAL MANAGER OF OPERATIONS FOR PETERBILT MOTOR COMPANY IN DENTON

For iconic heavy-duty truck manufacturer Peterbilt, Texas' advantages include geography and government collaboration.

"With proximity to interstates and major highways, North Texas serves as a convenient, cost-effective point of origin to serve our more than 300 dealer locations," says Leon Handt, assistant general manager of operations for Peterbilt Motor Company in Denton. "Texas has a deep resource pool for skilled, educated employees," he says, adding that the relatively low cost of living helps Peterbilt recruit and retain workers here.

"And Texas is proactive in attracting and keeping corporations," Handt says. "Government at all levels — local, county and state — creates collaborative relationships with companies and provides incentives to conduct business here."

HELPING THE INDUSTRY ACCELERATE

For McAllen, the city's location is a big draw.

"As a Border community, we focus on developing both sides of the river," says McAllen Economic Development Corporation (EDC) President and CEO Keith Patridge. "We look at McAllen and Reynosa [Mexico] as one metro area with a river running through it. The south side has some of the most competitive labor rates in the world. And the north side is the largest market in the world."

KEITH PATRIDGE

PRESIDENT AND CEO, MCALLEN ECONOMIC DEVELOPMENT CORPORATION

McAllen EDC has used that cost-competitiveness to attract automotive companies to the area. "Over the 27 years the EDC has existed, we've recruited more than 650 companies to McAllen and Reynosa, and 55 to 60 of those are automotive suppliers."

In Bexar County, the 2003 launch of the Toyota Tundra manufacturing plant was accompanied by the arrival of major suppliers to the company, several of which teamed with local partners to assist them in becoming direct suppliers to Toyota as well.

Texas ranks sixth nationally in automotive manufacturing employment, and second in the value of its exports of transportation equipment.

"Part of what makes a plant efficient is the density and proximity of its suppliers to the mothership," says David Marquez, executive director of Bexar County Economic Development. "That reduces the cost of logistics and the risk associated with supply chain distance."

The Bexar EDC has taken this concept to the next level by creating the Texas-Mexico Automotive Supercluster (TMASC), a public-private initiative with both Mexican and American partners that promotes the growth and development of the region's automotive industry.

SKILLED WORKFORCE NEEDED

Today, the U.S. is seeing some resurgence in auto manufacturing. Some competing nations have seen their costs and regulatory burdens rise, while in the U.S. energy and transportation costs have fallen and streamlined technical processes have improved productivity. The upturn has even resulted in "reshoring," the return of some manufacturing jobs to America.

But Texas will need an adequate employee base to keep its share of the automotive industry in motion. The state's relatively high birth rates and young workforce equate to a large supply of labor that should continue into the foreseeable future. In McAllen, for instance, Patridge reports that the average worker's age is around 28.

And need more workers with specialty skills, Marquez says.

"Someone who can run an automotive welding robot or a totally automated, multi-spindled lathe — that's a rare skill," he says. "It takes more than a short class to produce a skilled journeyman."

Patridge concurs this is a challenge in McAllen. "We're working closely with South Texas College, the University of Texas at Rio Grande Valley and public schools, reaching down into middle school to start focusing kids on opportunities that exist in technical areas."

GM, whose Arlington plant celebrated its 60th anniversary last year, recently partnered with Tarrant County College to implement a program funded by a November 2013 Skills Development Fund grant from the Texas Workforce Commission.

With the $868,179 grant, "the program trained more than 500 new and incumbent workers in hydraulics and pneumatics, welding, carpentry maintenance, project

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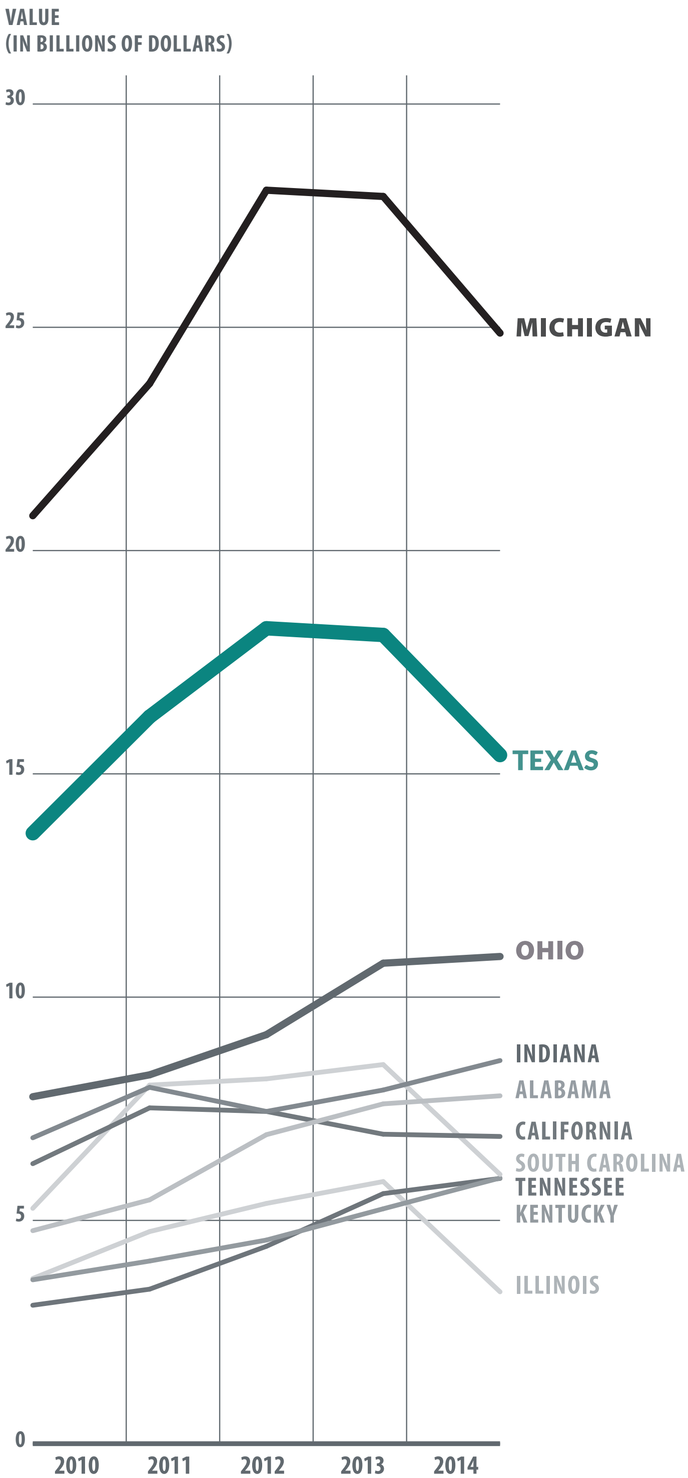
A MAJOR AUTOMOTIVE EXPORTER

Texas is second only to Michigan in the value of its autmotive exports.

Automotive Exports by State, 2010-2014

(Exports of motor vehicles, vehicle bodies, trailers and parts)

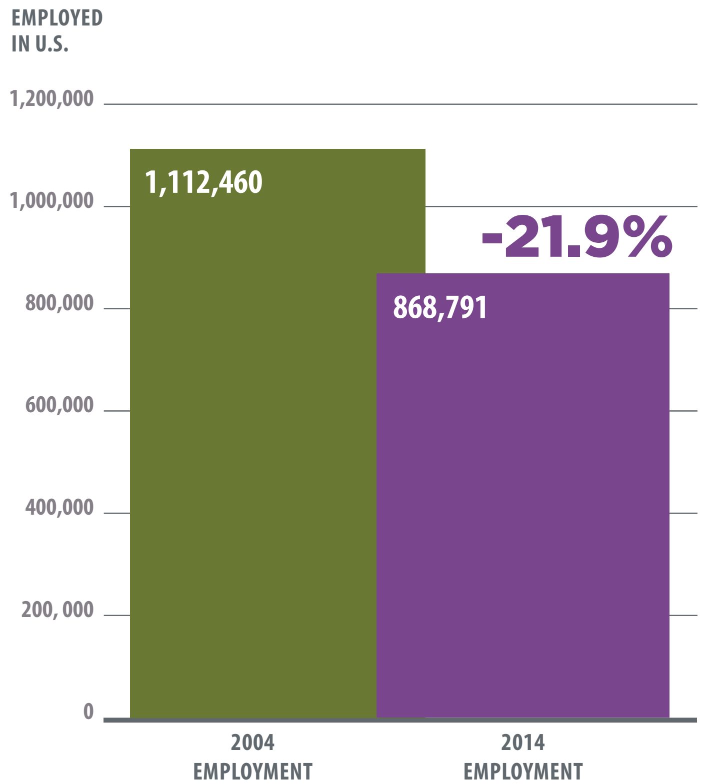


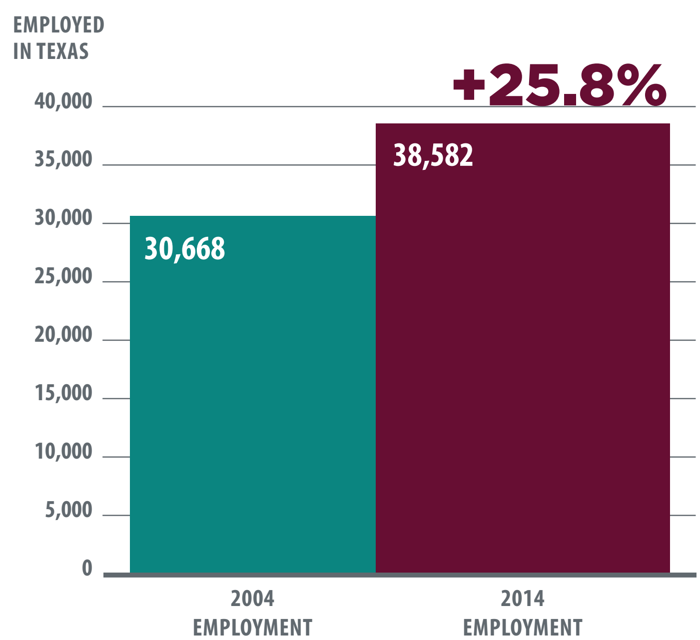
Source U.S. Census Bureau Foreign Trade Division

U.S. DOWN, TEXAS UP

In the last 10 years, U.S. automotive manufacturing employment declined significantly, but rose in Texas.

(Employment in the manufacture of motor vehicles, vehicle bodies, trailers and parts)





Source: Economic Modeling Specialists International

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management and more," says Bob Ferguson, GM's senior vice president for Global Public Policy. "Those trained will include electricians, stationary engineers, toolmakers, millwrights and industrial engineers."

WELCOME BACK, SHOP CLASS!

Both Patridge and Marquez specifically mention a fairly recent development in Texas education.

Under the 2013 Texas Legislature's House Bill 5, high school students can earn credit toward graduation by pursuing their interests in one of five elective tracks (although some school districts do not offer all five). Ninth-grade students now are required to select a specific area of study, called an "endorsement," which will help prepare them for college, technical school or the workplace.

Supporters hope school districts that have previously eliminated technical training programs may revive them for students working toward the business and industry endorsement.

For the automotive industry, HB 5 means coursework in areas such as welding and automotive technology can count toward graduation. Students also may be able to earn industry-recognized licenses or certifications. And districts can partner with community colleges and industry to develop courses that address workforce needs and provide technical training.

Patridge says this is the skills development the industry wants — "High school juniors and seniors [who] are working toward an associate's degree while in high school."

TRAINING ON THE JOB

Of course, many manufacturers have their own employee training programs.

"We provide comprehensive, ongoing training for all positions," Handt reports. "Peterbilt utilizes both internal and external training resources, and our competitive benefits package provides incentives for continuing education and tuition reimbursement."

GM has several initiatives that encourage and support education in science, technology, engineering and mathematics (STEM) and other fields important to the automotive industry.

"Our Buick Achievers Scholarship Program has awarded more than $2 million in scholarships to 72 Texas students since the program began," says Ferguson. The scholarships are available to students attending accredited four-year colleges and universities.

School districts that have eliminated technical training programs may revive them for students working toward the business and industry endorsement.

Buick Achievers Scholarships are available to students attending accredited four-year colleges and universities.

GM's University/Partner Organization Program, moreover, provides annual grants to institutions and professional organizations in STEM and other fields. In the past five years, the University of Texas at Austin, University of Texas at El Paso, University of Texas at San Antonio and Texas Tech have received nearly $700,000 combined.

STRATEGIES FOR A STRONG FUTURE

The outlook is bright for Texas' automotive industry. In McAllen, that means support companies.

[Last summer] we had 120 Japanese supplier companies all in town at the same time," Patridge says. "We're currently working to bring in another 100 to 110 suppliers to show them what we have to offer. By maintaining our supplier presence, we hope companies will continue to look at the border as a strategic location to serve auto clusters both in the United States and Mexico."

He also hopes the region will attract more applied research and development (R&D), an important and well-paid aspect of the industry. Four Japanese companies are already undertaking R&D activities in the McAllen area.

TMASC plans to update its 2012 market study and develop a new collaboration strategy to build renewed interest in the initiative.

"We're ready to get back out there with our message," Marquez says.

But Texas will need skilled workers, and recruiting the best talent will play a vital role.

"Training is a critical part of the solution, but the rest lies in attracting people from around the country or around the world to generate economic activity in Texas," Marquez says.

"Companies need to come up with creative ways to recruit," he says. "We should use the same strategies we use to attract companies to attract employees with the skill sets we need. That's a critical, competitive element." **FN**

MARKETING TWO NATIONS: THE TEXAS-MEXICO AUTOMOTIVE SUPERCLUSTER

When Toyota came to San Antonio in 2005, "it was like coming to the frontier without their backups," says David Marquez, executive director of Bexar County Economic Development. Where would the company find the suppliers needed to keep the production line going?

It was time for Marquez's office to get creative.

"The Toyota project taught us the important role counties can play in economic development," Marquez says. "This community came together to offer Toyota 3,000 acres, but County Judge Nelson Wolff and [former Toyota senior vice president] Dennis Cuneo deserve the credit for enabling Toyota to build its first-ever onsite supplier park. We were originally expecting 15 onsite suppliers. Today, we're at 23 and counting!"

Bexar County Economic Development did more than that, though. It created a binational, collaborative marketing strategy to bring manufacturers and suppliers together: the Texas-Mexico Automotive Supercluster (TMASC).

The TMASC initiative is focused on the supply chain, says Marquez. "Toyota wanted its Tier 1s to be as close as possible. The Tier 1s want their Tier 2 suppliers to be close. These Tier 2s need to be where they can serve multiple customers. But having only one plant in the area [Toyota] didn't represent enough volume for these suppliers to justify building in Texas.

"That drove us to start thinking about the original equipment manufacturing plant as the supply chain nexus: all these rivers of supplies converging on south Bexar County," Marquez says. "It became obvious that the goal had to be building this industry in Texas."

And to do that, TMASC needed to get Mexico's automotive industry on board.

"In North America, 80 to 90 percent of Tier 1 suppliers are within 400 miles of the plant," Marquez says. "If you draw that circle around our Toyota plant, you didn't find much there in the U.S."

But five Mexican states fall within that 400-mile radius, and many of Toyota's Tier 1 and 2 suppliers are in Mexico. (These suppliers existed in Mexico before Toyota located in San Antonio.)

"We needed to include facilities in Mexico to show companies an accurate picture of the market and the benefits of our local economy," Marquez says. "We needed Texas and Mexico to win more manufacturer battles. Even though San Antonio had Toyota, this would help convince other manufacturers to come to the Valley, Waco, Houston or even into Northeastern Mexico to add industry depth and density."

TMASC's efforts continue today, as its stakeholders and partners share market intelligence and collaborate on foreign investment projects. The group also pursues the heavy truck, other transportation and Tier 2 supply industries — anything that will help build volume.

"We've had successes throughout, including the arrival of [Toyota] Tacoma production to the San Antonio plant," Marquez says. "But the industry is in a real North American growth mode, with Kia announcing a plant near Saltillo, and BMW building one in San Luis Potosí. It's high time for Texas to get its share."

Marquez says you have to first convince the automotive manufacturers that you have a place where they can do business, but ultimately the goal is to tackle and resolve problems in a strategic way.

"We think we've influenced a lot of what's going on in this community that the city, workforce and even Toyota are picking up on. We're still sold on the TMASC effort as a prospect-generating exercise for the state, and those regional wins will ultimately benefit our Toyota plant." **FN**

THE AUTOMOTIVE MANUFACTURING ECOSYSTEM

OEM ORIGINAL EQUIPMENT MANUFACTURER

THE OEM IS THE COMPANY THAT MAKES THE FINAL PRODUCT (FOR EXAMPLE, GM OR TOYOTA).

TIER 1

TIER 1 COMPANIES SUPPLY MAJOR PARTS (SUCH AS STARTERS OR GENERATORS) DIRECTLY TO AN OEM, AND TYPICALLY ARE LOCATED IN CLOSE PROXIMITY TO THE OEM'S FACILITIES.

TIER 2

TIER 2 COMPANIES SUPPLY COMPONENTS TO TIER 1s (SUCH AS WIRE OR STAMPED METAL COMPONENTS).

TIER 3

TIER 3 COMPANIES SUPPLY TIER 2s WITH RAW MATERIAL, SUCH AS STEEL OR COPPER.

Mexico's Energy Deregulation Could Benefit Texas

by Patrick Graves

"DENATIONALIZATION" TO BOOST BUSINESS

In the near future, Mexico's energy industry will undergo a seismic shift — and so will Texas.

For the first time since Mexico nationalized its energy production in 1938, Texas' top trading partner is opening most of its oil and gas (O&G) fields to private development. The Mexican government is hoping to lure new investment to reverse years of lackluster performance and boost its primary revenue source.

Despite its ample resources, Mexico is a net importer of refined petroleum products. In May 2014, *The Wall Street Journal* reported that Mexico had begun running a negative petroleum trade balance with the U.S. for the first time in 40 years.

The resurgence of the U.S. energy industry has had worldwide effects on energy production. The Western Hemisphere is "the new center of gravity for oil and gas production," declares the Atlantic Council's Robert E. Manning. And Mexico, America's second most-important trading partner, wants to cash in.

Mexico's Energy Ministry should begin auctioning scores of exploratory tracts by midsummer 2015.

UNTAPPED RESOURCES

Mexico already is among the world's top 10 crude oil producers, and has even greater production potential. *Oil and Gas Journal* ranks Mexico eighth globally for recoverable shale oil and sixth in shale gas potential. Its national oil company Petróleos Mexicanos — commonly called Pemex — oversees fields holding the equivalent of an estimated 20.6 billion barrels of oil, including 13.4 billion in proven (commercially recoverable) reserves. Pemex has estimated the nation's overall petroleum resources at the equivalent of 115 billion barrels.

So much of Mexico's energy resources remain untapped that the U.S. Energy Information Administration believes its crude oil production will increase by 75 percent by 2040. Some industry insiders think serious drilling activity in Mexico is three to five years away, however, due in no small part to the recent plunge in oil prices. And, as any wildcatter knows, success is by no means guaranteed.

Mexico is developing a regulatory structure for independent producers. Other issues concerning equipment, infrastructure, security and liability must be resolved as well.

Unsurprisingly, the world's largest energy companies are expected to compete for many of the new opportunities, especially the riskier, costlier ventures. Likely players include BP, Chevron, Royal Dutch Shell, Brazil's Petrobras and Irving's ExxonMobil, which signed a cooperative agreement to exchange information with Pemex in October 2014.

The Mexican government is hoping to lure new investment to reverse years of lackluster performance and boost its primary revenue source.

WHO'S ON FIRST?

But the majors won't have it all to themselves. In late September 2014, Australian producer BHP Billiton Ltd. announced it had signed a preliminary agreement with Pemex to exchange deepwater expertise and information. Noble Energy Inc., a Houston independent, reportedly has expressed interest as well.

Asian companies are queuing up as well, including India's ONGC. During a trip to China last November, Mexican President Enrique Peña Nieto announced $5 billion worth of planned Chinese investments in Pemex projects.

Because Pemex wants to enhance recovery from its older, less productive fields, opportunities abound for O&G service companies such as Schlumberger, Weatherford, the soon-to-be merged Halliburton and Baker Hughes — all with headquarters or corporate offices in Houston — and Fluor, based in Irving.

Service contractors that have been working with Pemex since some modest legislative reforms in 2008 are the most likely to capitalize early on. Conversion to joint ventures (JVs) with Pemex should make billions more available to Mexico for exploration and production.

Mexico needs upgraded technology and greater expertise to extract oil and gas from "tight" (semi- or non-permeable) formations. Texas is the "epicenter" of this technology, says John Auers, executive vice president of Turner, Mason & Company, a Dallas engineering consultancy. Consequently, Texas has the most companies capable of assisting Mexico, Auers says, adding that it's "catching the U.S. industry at a good time."

JOHN AUERS

EXECUTIVE VICE PRESIDENT OF TURNER, MASON & COMPANY

STATE OF PLAYS

Mexico offers mature fields (both on- and offshore), deepwater drilling opportunities and tight shale plays — and all three sectors are likely to see new production. All but one of its producing areas are located in the eastern part of the country, in an arc stretching from the Texas border to the Yucatán Peninsula.

The majority of its mature fields and tight formations straddle the coastline. "Shallow" offshore drilling (in 400 meters of water or less) occurs mainly near Tampico and then south and eastward, as well as in the Perdido Basin a few hundred miles due east of Matamoros, opposite Brownsville.

MAJOR MEXICO OIL AND GAS FIELDS

Several major oil and gas deposits in Eastern Mexico are likely to attract significant production activity under deregulation.

Source: *Southwest Economy*, Federal Reserve Bank of Dallas, Second Quarter 2014

Mexico offers mature fields (both on- and offshore), deepwater drilling opportunities and tight shale plays — and all three sectors are likely to see new production.

Deepwater drilling (400+ meters) — common in the Gulf of Mexico's northern half, but virtually nonexistent under Pemex — could span much of the gulf's southern region, encompassing most of the Bay of Campeche and extending east to northern Yucatán.

Among Mexico's top priorities is rejuvenating its aging Cantarell Field in the bay's eastern section. Once the world's third-largest oil reserve, it has been producing up to 25 percent water recently, causing officials to revise production reports downward. This type of play should appeal to the major integrated oil corporations, Auers says, as well as larger independents such as Houston's Occidental Petroleum and The Woodlands' Anadarko. Pemex hopes to have several JVs in Cantarell by year's end.

Four-fifths of Mexico's oil production comes from its mature fields, mainly shallow offshore sites. To supplement them, Pemex is actively exploring deepwater areas in the Perdido Basin and has announced several discoveries in ultra-deepwater (1,500+ meters). Pemex plans to seek deepwater partners and will allot two partnerships for the more challenging ultra-deepwater exploration.

Another longer-term goal is greater exploration of tight rock formations. Mexico shares the Eagle Ford shale with Texas, for instance, but has drilled only about 20 exploratory wells on its side.

Some international independents may try to do business across all three sectors, Auers says, especially inland. More than half of the oil blocks up for auction are located northeast of Mexico City in the underachieving Chicontepec Basin. Pemex hopes new operators will succeed where previous contractors have failed to boost production in this geologically complex, technologically challenging region.

CONTINUED ON PAGE 12

Mexico shares the Eagle Ford shale with Texas, but has drilled fewer than 20 exploratory wells on its side.

BIG BUCKS FOR TEXAS?

Mexico's plans for its energy resources may pay large dividends for Texas.

Economists at BBVA Compass, a U.S. commercial bank having the same corporate owner as Mexico's largest bank, estimate that by 2018 Texas could gain about 217,000 jobs and $45 billion in additional gross state product from Mexico's energy reforms. Of that, South Texas could add more than 40,000 jobs and $5.6 billion in economic activity.

It should be noted, however, that BBVA's estimates were prepared before the precipitous drop in oil prices seen in recent months, and include assumptions such as a "smooth adoption of new technologies" and effective regulatory implementation on Mexico's part. Its analysis also doesn't touch on the possibility that significant increases in Mexican drilling might redirect resources *away* from Texas, thus having an offsetting effect on the state's production.

Mexico refines relatively little of its own crude, and experts think its refining activity is unlikely to expand anytime soon. But if larger regional facilities max out capacity, increased production could mean more business for smaller Texas refineries, says Tom Fullerton, an economics professor at the University of Texas at El Paso.

Mexico's plans for its energy resources may pay large dividends for Texas.

As for human resources, Jesus Cañas, an economist at the Federal Reserve Bank of Dallas, sees plenty of training opportunities for Texas companies despite possible logistical problems and skilled labor shortages. Noting that shale O&G deposits often are in rural areas, his colleague Michael Plante envisions an influx of foreign workers creating boomtowns in Northern Mexico similar to those in the Texas Eagle Ford area.

GOING SLOW?

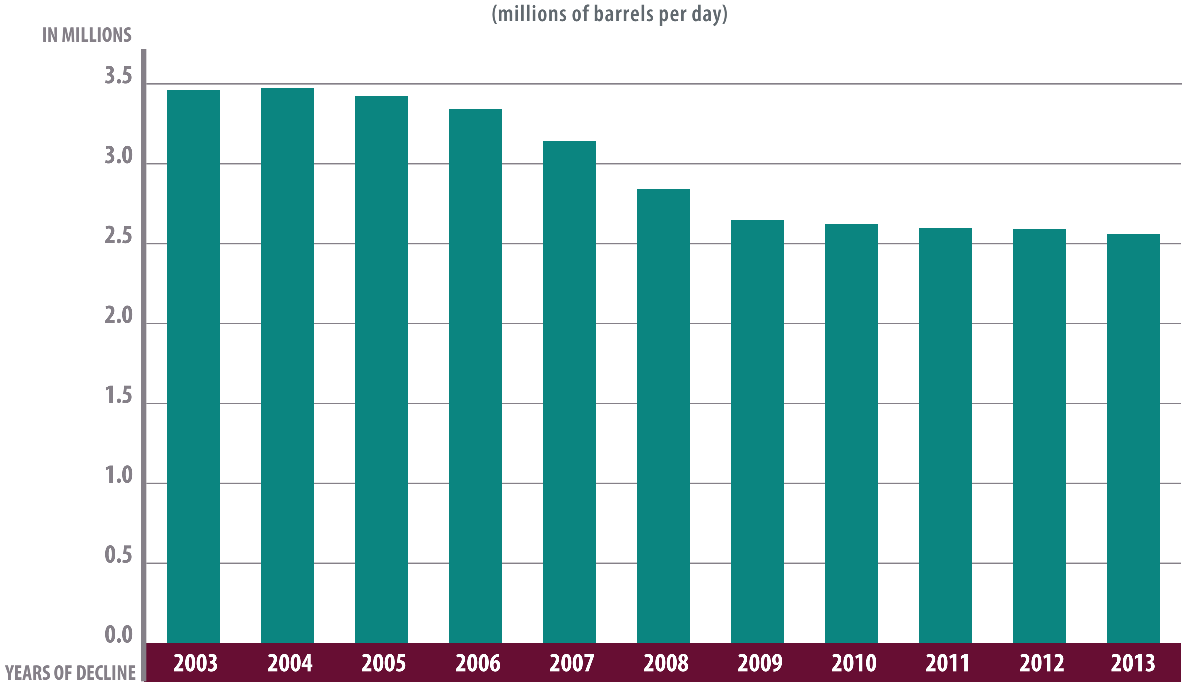
Some analysts and investors are less bullish on Mexico's ambitions, however. The University of Oxford's Institute for Energy Studies has called Pemex's growth projections unrealistic. In a June 2014 paper, it argues that new production won't offset ongoing declines and that Mexico's deepwater reserves can't be tapped in an economically competitive way — a critique that may seem prescient now, given current oil prices.

Successful denationalization will require huge outside investments. In April 2014, business strategists at the Boston Consulting Group estimated that fully developing Pemex's reserves would cost $830 billion.

YEARS OF DECLINE

Mexico's oil and gas reserves are among the world's largest, but its actual production has been falling for years.

Mexico Annual Crude Oil Production, 2003-2013
(millions of barrels per day)



Source: U.S. Energy Information Administration

The Mexican government, in turn, has said it needs $230 billion for energy projects in the next five years.

Regardless, Auers expects a "slow go" for investors until Mexico demonstrates it can open its fields to competition efficiently, profitably and sustainably.

With production up and demand down, depressing prices rapidly in 2015, drilling is slowing noticeably. But if prices climb back into the $80 to $90 range — and Auers believes they will, eventually — the "shale gale" should resume. The floor of profitability is still being determined (and it varies geographically), but he allows that a price correction was overdue. Other analysts see soft prices continuing for awhile, as additional output is marketed.

"OPEC's decision to not cut production was certainly a key component in the acceleration of the decline," Auers says.

Although the combination of strong supply growth and slowing demand has led to an oversupplied environment, Auers does not believe that the recent price collapse will be as damaging to the petroleum industry as that of the mid-1980s. This is due to both a fundamentally stronger and more nimble domestic energy sector and a weaker and less capable OPEC. Mexico is hoping that he's right. **FN**

The Mexican government has said it needs $230 billion for energy projects in the next five years.

CLASSICAL GAS

Mexico is simultaneously reforming its energy and electricity industries. Texas' proximity should be a boon to the state's natural gas suppliers as Mexico "amps up" its electric power grid.

Plans are under way to send Mexico more Texas gas to run new and expanded power plants. In 2015, Dallas' Energy Transfer plans to add 75 miles of pipeline, including an extension from Edinburg to a new crossing point near McAllen, to provide Mexico's electric power agency with almost 1 billion Btu of gas per day. And NET Midstream of Houston is completing a pipeline from Nueces County to near Rio Grande City for a subsidiary of Mexico's national gas company.

With demand rising, experts say Mexico's consumption could go up 20 percent.

WHY IT MATTERS: CERTIFYING THE 2016-2017 TEXAS STATE BUDGET

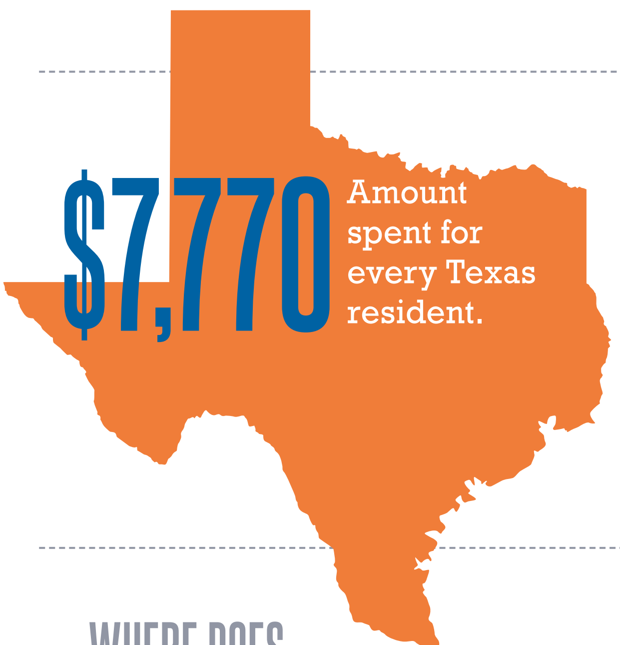
Comptroller Glenn Hegar certified that the Legislature's new budget is within his revenue estimate.* The budget will direct state spending for fiscal 2016 and 2017. It cannot go into effect without the Comptroller's certification.

JUNE 9 Date the Comptroller certified the budget.

THE BIG NUMBER:

$209.4 BILLION

That's how much Texas state government will spend over the next two years.

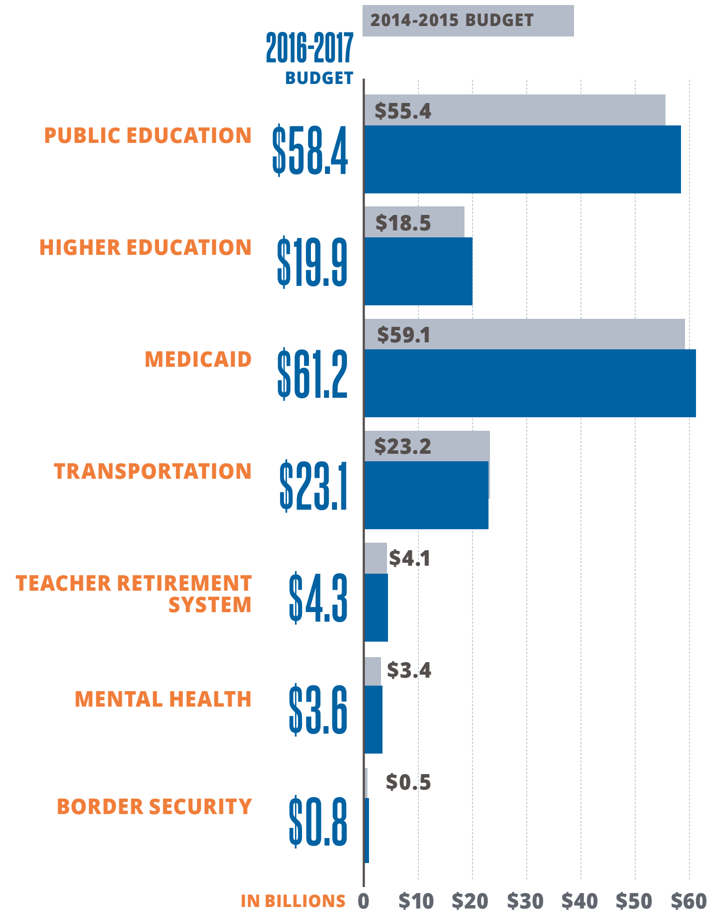


$7,770 Amount spent for every Texas resident.

WHERE DOES THE MONEY COME FROM?

- State taxes
- Federal grants, allocations, payments and reimbursements
- Fees, fines, trust fund revenue, bond proceeds and other nontax revenue

BUDGET HIGHLIGHTS:



The budget includes **$106.6 BILLION** in General Revenue spending.

TAX RELIEF

Businesses will receive a $2.6 billion break over the next two years due to lower franchise tax rates. Homeowners will receive $1.2 billion in property tax relief **IF** voters approve an increase in the homestead exemption in November.

*The Legislature can make appropriations in excess of anticipated revenue only in the case of an emergency with a four-fifths majority vote of both houses.

Budget Highlights Source: Legislative Budget Board, *Summary of Conference Committee Report for House Bill 1: Appropriations for the 2016–17 Biennium.*

State Revenue Watch FOR JUNE 2015

This table presents data on net state revenue collections by source. It includes most recent monthly collections, year-to-date (YTD) totals for the current fiscal year and a comparison of current YTD totals with those in the equivalent period of the previous fiscal year.

NOTE: Texas' fiscal year begins on September 1 and ends on August 31.

NET STATE REVENUE — All Funds Excluding Trust

(AMOUNTS IN THOUSANDS)

Monthly and Year-to-Date Collections: Percent Change From Previous Year

Tax Collections by Major Tax	MAY 2015	YEAR TO DATE: TOTAL	YEAR TO DATE: CHANGE FROM PREVIOUS YEAR
SALES TAX	$2,589,704	$21,705,439	7.43%
PERCENT CHANGE FROM MAY 2014	5.21%		
MOTOR VEHICLE SALES AND RENTAL TAXES	238,328	3,255,197	8.15%
PERCENT CHANGE FROM MAY 2014	-34.52%		
MOTOR FUEL TAXES	289,620	2,568,496	4.71%
PERCENT CHANGE FROM MAY 2014	2.16%		
FRANCHISE TAX	4,325,457	4,433,992	-2.04%
PERCENT CHANGE FROM MAY 2014	1.97%		
INSURANCE TAXES	22,159	1,241,281	3.66%
PERCENT CHANGE FROM MAY 2014	-24.08%		
NATURAL GAS PRODUCTION TAX	65,737	1,021,978	-22.30%
PERCENT CHANGE FROM MAY 2014	-54.99%		
CIGARETTE AND TOBACCO TAXES	121,663	1,082,551	9.66%
PERCENT CHANGE FROM MAY 2014	-4.24%		
ALCOHOLIC BEVERAGES TAXES	96,290	842,438	9.14%
PERCENT CHANGE FROM MAY 2014	4.47%		
OIL PRODUCTION AND REGULATION TAXES	206,837	2,230,217	-20.42%
PERCENT CHANGE FROM MAY 2014	-38.22%		
INHERITANCE TAX	(3,792)	(3,825)	-33,233.84%
PERCENT CHANGE FROM MAY 2014	N/A		
UTILITY TAXES[1]	9,171	334,777	3.07%
PERCENT CHANGE FROM MAY 2014	106.80%		
HOTEL OCCUPANCY TAX	45,484	381,181	9.72%
PERCENT CHANGE FROM MAY 2014	3.41%		
OTHER TAXES[2]	21,685	217,999	12.91%
PERCENT CHANGE FROM MAY 2014	-10.80%		
TOTAL TAX COLLECTIONS	$8,028,343	$39,311,720	3.09%
PERCENT CHANGE FROM MAY 2014	-1.53%		

Revenue By Source	MAY 2015	YEAR TO DATE: TOTAL	YEAR TO DATE: CHANGE FROM PREVIOUS YEAR
TOTAL TAX COLLECTIONS	$8,028,343	$39,311,720	3.09%
PERCENT CHANGE FROM MAY 2014	-1.53%		
FEDERAL INCOME	3,280,282	26,936,651	9.25%
PERCENT CHANGE FROM MAY 2014	25.73%		
LICENSES, FEES, PERMITS, FINES AND PENALTIES	891,544	6,967,433	21.16%
PERCENT CHANGE FROM MAY 2014	73.19%		
INTEREST AND INVESTMENT INCOME	238,530	874,649	-12.06%
PERCENT CHANGE FROM MAY 2014	205.44%		
LOTTERY PROCEEDS[3]	150,052	1,439,934	-0.74%
PERCENT CHANGE FROM MAY 2014	7.92%		
SALES OF GOODS AND SERVICES	18,837	318,310	66.49%
PERCENT CHANGE FROM MAY 2014	-12.51%		
SETTLEMENTS OF CLAIMS	1,754	526,308	-6.53%
PERCENT CHANGE FROM MAY 2014	-77.29%		
LAND INCOME	87,636	1,206,656	-12.55%
PERCENT CHANGE FROM MAY 2014	-35.22%		
CONTRIBUTIONS TO EMPLOYEE BENEFITS	4	44	-37.74%
PERCENT CHANGE FROM MAY 2014	-24.47%		
OTHER REVENUE SOURCES	370,004	3,642,613	16.49%
PERCENT CHANGE FROM MAY 2014	-11.95%		
TOTAL NET REVENUE	$13,066,987	$81,224,318	5.95%
PERCENT CHANGE FROM MAY 2014	8.18%		

1- Includes public utility gross receipts assessment, gas, electric and water utility taxes and gas utility pipeline tax.

2- Includes cement and sulphur taxes and other occupation and gross receipt taxes not separately identified.

3- Gross sales less retailer commissions and the smaller prizes paid by retailers.

Note: Totals may not add due to rounding.

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Fiscal Notes also provides a periodic summary of the financial statements for the State of Texas.

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