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Mexico Executes Another Hedge in Financial Markets to Protect Oil Revenues in 2017

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The Mexican government has begun to take steps to protect revenues from oil exports by making use of a tool in the financial markets that guarantees a certain price level. The downturn of the global oil market in recent years has forced the finance ministry (Secretaría de Hacienda y Crédito Público, SHCP) to use this maneuver, known as an oil hedge, in the last two years (SourceMex, Feb. 4, 2015, and Feb. 10, 2016). The government also resorted to acquiring hedging contracts in response to an earlier slump in the global oil market in 2008 (SourceMex, Nov. 19, 2008).

Hedge price set at US$46 per barrel

The hedge for 2017 is not yet complete, but authorities said the process is designed to ensure a price of US$46 per barrel for Mexican oil exports next year. That would be slightly below the prices of US$49 guaranteed with a hedge for 2016, and US$53 for 2015. The plan to cover oil prices is the largest of its kind by any nation in the oil markets this year, according to Reuters.

Some analysts believe that the hedge price of US$46 per barrel is risky. “Our oil is heavier and contains a higher sulfur content, and therefore it carries a lower value,” analyst Jonathan Ruiz wrote in the daily business newspaper El Financiero. Because of that, he pointed out, the true price of the hedge should be closer to US$36.35 per barrel.

Despite the concern, the SHCP is moving forward with the hedge. “We have advanced in an important way; we still haven’t finished the process, but the vast majority of the options, that is to say the hedge, have already been acquired,” Finance Secretary Luis Videgaray told reporters in Monterrey on Aug. 16.

PEMEX, the state-run oil company, began the current hedge operation in June and July 2016, when prices for oil futures were considered at their peak, rather than during the traditional hedging period of August-September.

Despite efforts to reform the tax code and diversify the source of revenues, the Mexican government continues to rely heavily on oil-export revenues to fund the federal budget (SourceMex, Oct. 11, 2000, Sept. 19, 2007, and Oct. 23, 2013). This scheme has proven to be detrimental in recent years because of the global slump in oil prices (SourceMex, Feb. 4, 2015, and Aug. 19, 2015).

However, there has been some progress in weaning Mexico off oil revenues to fund the budget. According to The Wall Street Journal, roughly 18% of Mexico’s federal budget came from oil revenues in the first half of 2016. This compares with 30% of the budget during the same period in 2015.

Conversely, the weak global market has forced PEMEX to rely increasingly on support from the government to pay its debts to subcontractors and meet commitments to workers. The drop-off in revenues for PEMEX forced the SHCP to inject about US$4.2 billion to PEMEX earlier this
year to help improve the oil company’s liquidity and help to make this year’s pension payments (SourceMex, May 4, 2016).

In recent comments to analysts from the rating agency Moody’s, PEMEX director José Antonio González Anaya offered assurances that the company has already paid about 120 billion pesos (US$6.37 billion) of its debt to subcontractors. He made the statement just after Moody’s lowered PEMEX’s debt rating.

**Global oil market remains weak**

In addition to strengthening its debt standing on the global markets, PEMEX must put its finances in order to help attract partnerships with foreign private investors. For PEMEX, a major problem is the continued drop in oil reserves, which has limited production (SourceMex, March 7, 2007, and Aug. 1, 2012). In 2015, PEMEX reported output of 2.267 million barrels per day, the 11th consecutive year-on-year decline since it hit peak production of 3.38 million bpd in 2004. Output continued to decline in 2016, with production levels reported at an average of 2.208 million bpd in April and 2.180 bpd in May of this year, according to the US Energy Information Administration (EIA).

PEMEX is hoping to boost production by increasing drilling and exploration in the deep waters of the Gulf of Mexico. Currently, about 80% of Mexico’s production of crude oil comes from offshore shallow-water deposits.

To assist PEMEX in the scheme to access the deepwater reserves, the Mexican Congress approved an energy reform plan in 2013 that allows increased participation by private investors in exploration and extraction activities (SourceMex, Dec. 18, 2013, and Aug. 6, 2014). In June, Mexico’s hydrocarbons commission (Comisión Nacional de Hidrocarburos, CNH) approved a measure allowing PEMEX to seek a partner to conduct further exploration, and eventually extraction, in the oil field known as Trión 1 (SourceMex, June 29, 2016).

Even if Mexico were to increase production levels, the big uncertainty is whether its most reliable customers—particularly the US—will continue to be strong markets for Mexican crude. According to the EIA, the US almost doubled its own production of crude in recent years, going from 5.4 million bpd in 2010 to 9.4 million bpd in 2015.

The increased in US production has a strong correlation to Mexico’s exports of crude oil.

According to Mexico’s Economy Ministry (Secretaría de Economía, SE), the US accounted for 85.3% of Mexico’s crude oil exports in 2010, but that ratio has dropped to about 53.2%. The US has not only reduced imports of Mexican crude, but has replaced some of those purchases with Canadian crude, according to the EIA.

In terms of volume, the US reduced imports of Mexican crude by slightly more than 28% between 2008 and 2015, according to statistics from the US Department of Commerce (DOC). According to El Financiero, other regions—including some countries in the Far East and Europe—have also reduced their imports in recent years. The loss of sales to the US, Europe, and the Far East has resulted in a diversification of Mexico’s customer base. The second-largest market, Spain, now accounts for 13.4% of Mexico’s total exports, with Japan, South Korea, India, Italy, and the Dominican Republic also importing significant amounts of Mexican crude.

The big concern, however, is that the overall value of Mexican crude oil exports continues to decline, directly affecting the Mexican treasury. In the first quarter of this year, exports declined to just
under US$2.67 billion, the lowest level since 2002. The total was also about 48% below the value of
exports between January and March 2015.

The downward trend has continued in recent months. In July, for example, Mexican shipments
of crude declined to US$1.8 billion, a drop of more than 22% relative to the same month in 2015,
according to a late August report from the Instituto Nacional de Estadística y Geografía (INEGI),
Mexico’s semi-autonomous statistics agency.

**GDP forecast for 2016 lowered**

The weak oil market could create some uncertainties for President Enrique Peña Nieto’s
administration as it prepares the budget for 2017, which the SHCP will submit to Congress
sometime this month. The revenues portion of the budget (Presupuesto de Ingresos) relies heavily
on the projected oil price and a forecast for GDP growth.

A sluggish US and global economy has added further uncertainty to projected economic growth in
2017. In late August, the SHCP reduced its estimate for Mexico’s GDP growth for 2016 to between
2% and 2.6%. In May, it had projected a growth rate ranging between 2.2% and 3.2%.

Deputy finance secretary Fernando Aportela said the reduction was due to poor industrial
performance in the US, which is Mexico’s most important trading partner. “The factors and pillars
of the domestic market are functioning, but there is a complicated external factor, above all... a
weakness in US industrial production,” Aportela told reporters.

The relatively weak US economy was reflected in Mexico’s slow growth pattern in the second
quarter of the year, with the country’s GDP declining by 0.2% in April–June. The industrial sector,
which includes manufacturing and crude oil production, shrank by 1.5% in the second quarter.

“The economy’s tanking,” Luis Maizel, co-founder of LM Capital Group, told Bloomberg news
service. “How many times have they reduced growth expectations? How many times can you use
the same excuse, that the US economy is slowing so the Mexican economy is slowing down?”

In late August, S&P Global Ratings revised Mexico’s outlook to “negative” and suggested the
possibility of another downgrade in the next two years if the Peña Nieto government continues to
incur a large debt to finance an increase in expenditures.

“The expansion of spending has been significant for several years and comes at a time when you
have to rein in that expansion to reflect the long-term decline in oil prices,” economist Alonso
Cervera of Credit Suisse Group AG in Mexico City said in an interview with Bloomberg. “The room
for maneuver to stimulate the economy is limited. On the fiscal side, there’s no margin.”

Still, despite a 3% contraction in the Mexican oil sector relative to a year ago, analysts point out that
Mexico is in much better shape than other oil-dependent economies like Venezuela and Brazil.

“Mexico will continue to weather low oil prices better than the region’s other energy producers,”
noted Edward Glossop of the research firm Capital Economics.

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