

Economic Analysis

Considerations on AMLO's four energy proposals

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The next federal administration's energy policy will be a key factor influencing economic growth, the fiscal balance, investment and the transition to an energy model more geared towards renewables. For these reasons, the four proposals for the energy sector recently announced by AMLO (president-elect Andrés Manuel López Obrador) and his team are analyzed in this document.

One of these proposals plans to increase oil output from 1.9 to 2.5 million barrels a day by investing 75 billion more pesos in exploration and drilling. Another of the proposals deals will focus on the reconfiguration of the six refineries established in the country, since they are currently operating at just 30% of their capacity according to the figure mentioned by AMLO (Pemex reported 51.1% in 2017). His team contends that an additional investment of 49 billion pesos is required to raise their capacity to 100%.

The third proposal revolves around the construction of a new refinery that would represent an investment of 160 billion pesos, whose project is expected to begin in 2019. With the construction of this new refinery, the AMLO team sees Mexico ceasing to import gasoline by half-way through the government's six-year term. Finally, the fourth proposal aims to increase power generation by modernizing hydroelectric plants.

It would be positive that Pemex keeps promoting associations with the private sector and auctions of oil and gas reservoirs to continue to make it possible to boost oil production.

As for the proposed increase in oil production from 1.9 to 2.5 million barrels a day, we agree that more investment is needed in exploration and drilling in order to be able to bring the replacement rate for 1P (proven) reserves back to levels close to 100%. Not until this happens, oil production will stop declining. Although the discovery of major new oil and gas deposits resulting from the additional investment cannot be ruled out, we believe it would be desirable for Pemex to continue to take advantage of the new schemes for association with the private sector promoted by the Energy Reform. In particular, making the most of it in deep waters exploration, which is where Pemex can benefit most from the capital and know-how of private companies with experience in this field. This would serve the dual purpose of increasing the likelihood of finding these kinds of deposits and sharing the risks of investment in exploration and drilling. Moreover, these schemes would involve less capital expenditure by Pemex and therefore less fiscal pressure.

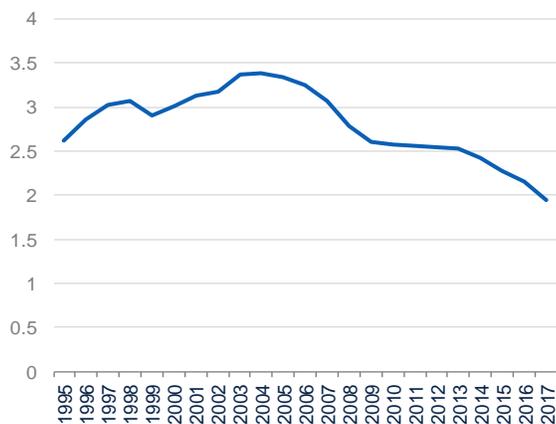
The aim of boosting oil production to 2.5 million barrels a day in two years does not strike us as realistic, even if it is done by means of public-private partnerships. Boosting oil output in the coming years will also require continuity in the auction rounds of hydrocarbon reservoirs. This factor will be crucial for reversing the decline in oil production and possibly boosting it at a faster rate over the next few years.

The reconfiguration of the refineries should be accompanied by a process that promotes efficiency in labor costs

The reconfiguration of the six refineries will very likely help them to operate at more than 30% of their capacity. In the past, some of them have been affected by non-scheduled technical stoppages due to shortages of inputs such as hydrogen, the lack of preventive maintenance and the effects of the 2017 earthquakes. Nonetheless, it is practically impossible to bring the refineries to 100% of their capacity due to the annual general maintenance work and the impossibility of complete elimination of incidents that might arise. Furthermore, in order to be able to maintain fiscal discipline given these additional investments in the energy sector, AMLO and his team would have to fulfil its promise to reduce the budget allocated to Pemex's union.

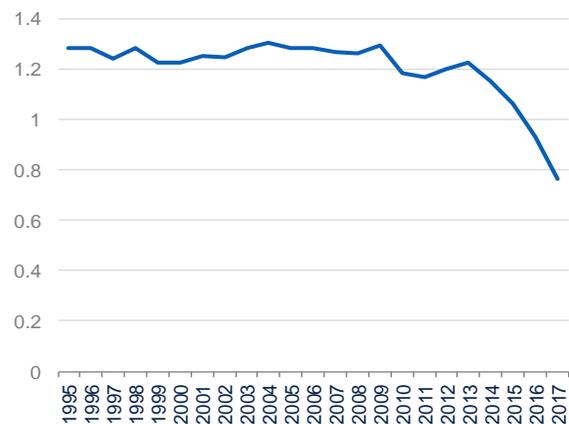
In our opinion, the burden of the Pemex's union payroll, fuel theft and corruption problems have been the main sources of financial losses in the company during these last few years of higher oil prices. According to a report by the Federal Commission on Economic Competition (Cofece), Pemex lost more than 100 billion pesos a year on refining between 2010 and 2015. These losses represented on average 0.6% of GDP during those years. We are convinced that, before investing in the reconfiguration of refineries and, above all, before building a new one, it would be desirable to resolve the company's efficiency problems. From an economic standpoint, it does not seem like a good idea to invest 49 billion pesos in an activity that is losing more than 100 billion pesos a year, particularly when we consider that gasoline could be imported at lower prices.

Figure 1. Crude oil production, (Millions of barrels a day)



Source: BBVA Research based on SIE (Energy Information System) data

Figure 2. Processing of crude oil in the six refineries, (Millions of barrels a day)



Source: BBVA Research based on SIE (Energy Information System) data

In relation to the proposal to build a new refinery, we think the cost is relatively high and could exert pressure on public finances and on Pemex's credit profile. However, we will have to wait for Pemex's next business plan to see how this refinery would be financed and whether an injection of capital is envisaged for the purpose. A public-private partnership for this project would undoubtedly be positive for public finances and Pemex's credit profile.

The proposal to modernise the hydroelectric plants is a positive sign for the configuration of the new administration's clean energy policy

Regarding the proposal to modernize the CFE (Federal Electricity Commission), it is laudable that this should be through hydroelectric plants, since this is clean energy. This proposal chimes with the national strategy of reaching the goal of generating 35% of electricity from non-fossil sources by 2024. Moreover, the modernization of the hydroelectric plants does not conflict with the new wind or solar power generation projects on which private sector companies have invested heavily both before and after the bidding processes for medium- and long-term power supply. Nonetheless, it will be interesting to see how the CFE rebalances its portfolio of generators following the considerable investment made in combined cycle plants in recent years.

Fiscal pressure

It is important to acknowledge that the above energy proposals would represent a cost of 0.8% of GDP and, consequently, appropriations for them will be part of the federal budget for 2019 (assuming the new refinery would require four years to start operations). This would imply an additional challenge to reach a primary fiscal surplus next year. Moreover, the rating agency Moody's has expressed concern that implementing the plans for the refineries would impair Pemex's creditworthiness if the associated investments were financed by debt, which could also have a crowding-out effect on the resources needed to increase oil and gas production.

It is important to have a public discussion of the idea of AMLO and his economic team of freezing the real price of gasoline. Although the initial conditions are favorable, given the relatively high international reference prices, the peso's appreciation in recent weeks could go reverse and work against the IEPS revenue if a price-freeze is sought. Nor can we rule out the possibility that, at some point during the six-year term international, oil prices will be above current levels and exert pressure on production costs in refining processes.

Price control policies, such as freezing real gasoline prices could have negative implications for public finances, especially when the Mexican peso goes through bouts of considerable depreciation against the US dollar or when there are sharp increases in international reference prices. Furthermore, introducing this kind of distortion into the gasoline market would be bad for the environment and might delay the country's adoption of cleaner means of transport. Finally, this freeze of gasoline real prices would constitute a regressive subsidy.

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