Economic Analysis

Recommendations for Pemex to Face a Cutback in Production

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April 14, 2020

- **Pemex should take advantage of the 100,000 barrels a day cutback to reduce capex in E&P in 2020. This policy action would boost its liquidity, improve chances of meeting its financial balance approved by Congress and avoid increasing its financial debt**
- **Given the significant increase in Pemex bonds yields, it is not recommendable that Pemex issues more debt from the perspective of its financial balance**
- **Processing more oil barrels in Pemex refining activities does not appear to be an economically viable solution to the replacement of gasoline and diesel imports, given Pemex's ongoing structural problems, namely obsolete plants, low levels of maintenance and labor inefficiencies**
- **The collapse of oil prices in recent weeks has had a significant impact on the public sector. We anticipate that oil revenues (including estimated profits from the 2020 oil hedges) will be 20% lower than the amount approved by Congress for this year**

OPEC and its allies have reached a historic agreement to cut global oil production by 9.7 million barrels per day (approximately 10% of the global production). Although Mexico had, like other countries, originally been asked to cut oil production by 23% (equivalent to 400 thousand barrels per day), Mexico proposed a reduction of only 100 thousand barrels per day. This proposal was eventually accepted mainly due to President Trump's commitment to support Mexico by reducing US production further by 250 thousand barrels per day.

We expect oil prices to remain low-for-longer. This is because the reduction in global oil production will not be sufficient to balance supply and demand, based on estimates that point to a drop in demand of 25 million barrels per day (demand before the COVID-19 outbreak was 100 million barrels per day). We therefore believe that Pemex should take advantage of this production cut in order to reduce investment expenditure on exploration and production (E&P) in 2020. This would allow it to increase its liquidity, have more leeway to be able to meet its financial balance approved by Congress and to avoid increasing its financial debt.

The collapse of oil prices in recent weeks has had a significant effect on the public sector. We anticipate that oil revenues (including estimated profits from the 2020 oil hedges) will be 20% lower than the amount approved by Congress for this year. With a reduction of 100 thousand barrels per day, we estimate the average output will be 1.71 million barrels per day in 2020. Assuming that around two-thirds of oil production is hedged at USD 49 per barrel, the remainder is priced at USD 24 per barrel, and DUC (*Derecho por Utilidad Compartida* or the profit-sharing-duty) of 54%, then profits (net income including extraction costs and DUC) from oil production would be around USD 2,620 million.

Without the restrictions agreed by OPEC+, comparable profits would have been USD 2,104 million. This calculation assumes an average production target of 1.85 million barrels per day, as published in the 2021 General Economic Policy Pre-Criteria document, and a finding and development (F&D) cost of USD 20 per barrel. While Pemex is focused on investing in the development of 22 new oil fields in 2020 to bolster its oil production, this decision is not supported by the above estimation as higher oil production will lead to lower profits. Production should also be reduced in all fields that are not profitable at the current price of the Mexican export crude oil mix.

In terms of refining activity at Pemex, the government announced that an additional 400 thousand barrels of oil would be used for that purpose this year. Although the intention is to reduce oil sales at a low price, the impact on Pemex's finances would be the same, because oil for domestic use would be quoted at the international price. Given that the average capacity used in Mexico's National Refining System is around 30% (as a result of low levels of maintenance and plants reconfiguration), it is very likely that an increase in refined products will lead to higher losses.

Given the uncertainty around the depth and duration of the imminent economic recession, ramping up domestic fuel production is by no means a sensible policy as it would not only crowd out more efficiently produced fuel imports, but also runs the high risk of causing a sizable increase in local fuel inventories (with the additional storage costs that this would imply).

Conclusions

The federal government and Pemex should take advantage of the 100 thousand barrels per day oil production cut starting in May to increase the oil company's liquidity by reducing investment spending on exploration and production this year. Combined with a tax saving of MXN 65 billion, this would most likely avoid an increase in corporate debt issuance or the need to use lines of banking credit in the event of liquidity problems.

Considering the significant increase in the Pemex's bond yields, it is not recommendable that the company issues debt. Pemex's 10-year bond yield in dollars currently stands at 10.2%, while the sovereign yield is 3.8%, equating to a differential of 6.4%. Given these conditions, Pemex should not be issuing debt. If necessary, the federal government should issue debt and/or inject capital to the state-owned production company.

As long as structural problems such as obsolete plants, low levels of maintenance and labor inefficiencies are not solved, processing more crude oil barrels in Pemex refining activities does not seem to be an economically viable solution to the substitution for gasoline and diesel imports. Indeed, such a decision would in fact result in higher losses. Furthermore, the significant economic contraction expected in 2020 calls for public resources to be used more efficiently to avoid putting additional pressure on public finances. We therefore suggest halting construction of the Dos Bocas refinery. Given the current sanitary emergency, we believe it would surely be more efficient and desirable to reallocate to the health sector the resources freed up by reducing oil exploration, production and refining activities.