The Impact of Lower Oil Prices on the Mexican Economy

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After three and a half years of price stability and very low volatility, in which Brent spot prices averaged more than $110 a barrel, the world oil benchmark fell 44 percent from the July monthly average to December 8, a drop of $49. Most of the drop took place after September 1, when Brent was still above $100 per barrel. At this juncture, establishing the trajectory that oil prices will follow in the short and mid-term is simply not possible. Market analysis can be enlightening, but one of its by-products, forecasting, is much less interesting. Those that claim that they can approximately determine the extent of further reductions, the rate of decline and the length of the period of low prices are either deluding themselves, very naïve or have a political agenda. They are guessing and certainly have not learned from the past. Predicting short- and mid-term prices is one more instance of human folly.

By the beginning of the second week of December, the price of the Mexican crude oil export mix had decreased 42 percent from the June monthly average peak. The main component of this mix is Maya heavy crude. Its differential with respect to the Brent spot price has steadily narrowed throughout the year, from $24.81 in January to $9.02 per barrel in October, due to excess supplies of light crudes in the Atlantic Basin. More recently this differential has begun to widen again and might further increase because of growing supplies of Canadian heavy crudes to the U.S. Gulf Coast. More than 200,000 barrels per day are now flowing and a substantial increase is expected once the Flanagan South and the Seaway twin pipelines are filled, expected at the end of 2014 and the beginning of 2015, respectively.

Mexico is relatively well protected from the recent fall in oil prices. As a net exporter of oil, higher prices are preferable to lower prices. However, low prices also offer opportunities that Mexico should seize, such as the full elimination of price subsidies. It has a more diversified economic structure than many other oil exporters. The contribution of the oil industry to GDP hovers around 6 percent. In the first half of 2014, revenues from oil exports –crude and products- were 12 percent of total merchandize exports.

It is in the area of public finances where oil plays a more important role, given the low tax burden of Mexico. In Latin America, only Guatemala and Haiti collect less taxes in relation to their GDP. Oil revenues have dropped from an amount equivalent to 8.6 percent in 2008 to 7.8 percent in 2013, when the government received 4.8 percentage points and Pemex kept 3.0 percent. Government oil receipts will continue to fall if prices drop further. The share of oil revenues in total federal government revenues will also tend to fall from the level of 31.7 percent attained in the first ten months of 2014. As Pemex gradually migrates from the current tax regime to the new one that will be applied to private parties entering the industry as part of the wider energy reform that is underway, this share will fall further, even if prices recover. The government will have to increase non-oil revenues to cover short-term fiscal deficits and mid-term rate reductions in oil taxes.

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For 2015 the government has partially hedged its oil revenues. The hedging program, possibly the largest in the world, has two components: 1) a combination of Maya and Brent put options at an average strike price of $76.40 per barrel for the Mexican export mix, with a cost of $773 million; and 2) an account that was opened within the Budget Revenue Stabilization Fund, with the equivalent of $587 million that covers the difference between the strike price and the $79.00 per barrel oil price premise assumed in the federal budget. A total of 228 million barrels were hedged, including the self-insured portion. This covers 57 percent of planned crude exports for 2015 and 26 percent of total planned production. Pemex itself does not have a price risk management mechanism in place beyond its traditional oil product trading and hedging activities. In 2014, the government's hedging program had an average strike price of $85 per barrel, at a cost of $543 million. This put option will not be exercised, as average prices up to mid-November were $92.40 per barrel. The Mexican government could benefit from greater flexibility with respect to the timing of its hedging programs, which are structured in September. This summer it might have taken advantage of exceptionally low volatility and, with hindsight, from higher prices.

The decline of Mexico's crude oil production has not yet bottomed out. It further declined in 2014 and it is not likely to reach the 2.40 million b/d target for 2015. It is more probable that it will remain flat at 2.35 million b/d, although the balance of risks is on the downside. Thus a combination of low prices and lower volumes will affect revenues. However, from a balance of trade perspective, the large and growing volume of product imports is a mitigating factor. Crude and oil product exports in the first 10 months of 2014 averaged 1.3 million b/d. However, net liquid hydrocarbon exports were only 715,000 b/d. In value terms, oil product imports absorbed close to 60 percent of crude and product exports.

Notwithstanding these production and export trends, it could be in Mexico's interest to cooperate with OPEC in a price recovery initiative, stabilizing prices at levels that are perceived as reasonable by both producers and consumers. It has done so in past price collapse episodes, engaging in negotiations with other producing and exporting countries. Under specific market conditions, and with good expectations of compliance by other players, it should benefit once again from collective action. It can cut production, as Pemex, a state oil company, will continue to be a dominant producer in Mexico for a long time to come. Consuming countries and the international oil industry would well understand its motives.

The impact of lower prices on the peso/dollar exchange rate is impossible to disentangle from other coincidental sources of uncertainty that have plagued Mexico's economy and society, as well as the recent strength of the dollar. In less than three months the peso has depreciated 8.7 percent. More important determinants are the downward revisions of GDP growth, allegations of impropriety by the political elite and serious security issues, all of which are affecting private sector confidence. Perceptions regarding the economic importance of oil reflect historical experience and the high profile given to the oil industry in the public discussion of structural reforms. Attributing the behavior of the exchange rate to the pricing of oil underestimates more important factors.

The government's efforts to eliminate generalized oil product subsidies have been helped by lower international prices. In 2012, for example, estimated subsidies for gasoline and diesel reached $15 billion and, by the end of 2014, they have essentially disappeared. The last scheduled monthly retail price adjustment of this year took place on December 6, and at the beginning of 2015, a further increase will be made to correct for expected yearly inflation. Meanwhile, US spot and retail prices have been falling significantly. The current price of regular gasoline at the pump in Mexico is $3.31 a gallon and the price of diesel is $3.72. These are 32 percent and 8 percent higher, respectively, than Houston retail prices, which is the reference that Mexicans tend to follow, and broadly over the US average. The Ministry of Finance has committed itself to refrain from granting oil product price subsidies during the transition to fully open and competitive final product markets on January 1, 2018. In these three years it will have to carry out challenging tasks. Prices at service stations will have to fully reflect transport and distribution costs, transfer prices need to be recalibrated and product import trading margins adjusted. More importantly, it must set the rules of the game in which competitive markets can develop. Eliminating subsidies is an important and necessary first step.

The Mexican government is concerned by the potential effect of lower prices on the success of the first round of bids on oil acreage recently opened to private investment, a key part of energy reform. The first invitation to bid is scheduled for the second week of December. Shallow-water exploration blocks close to the Tabasco coast will be auctioned. Early next year other shallow water fields, some of them containing important reserves of extra-heavy crude, will follow. In the first half of the year invitations to bid will also be released for the Chicontepec Basin and unconventional oil and gas blocks; and, finally, bids will be received for mature onshore fields and deep-water structures, close to the US maritime border and in the Southern Gulf of Mexico. It is a highly prospective, large-scale portfolio, with geographically and geophysically diverse structures, with light and extra-heavy crudes, associated and non-associated wet and dry natural gas and significant seismic and geological information. Selected fields have close analogues and are close to existing infrastructure.

Expected cost structures should attract ample investor interest at current and lower prices as investment decisions consider full cycle costs and long-term prices, not short-term market conditions. These, however, affect general industry investment climate and the level of capital expenditures in marginal fields and blocks. Potential bidders will argue that with lower prices, equity owners will insist on greater capital discipline and that global competition for capital will tend to intensify, both testing the competiveness of expected contractual terms and conditions. It is in this context that interested parties are prone to demand concessions. Mexico can resist this pressure given the relative quality of its offering. It is clearly on solid grounds to do so. If for some reason it were to underestimate the impact of current and mid-term market conditions in parts of the first round it can always make adjustments in a second round of bids. However, the mistake of granting unnecessary concessions is difficult to revert. The opening of the Mexican upstream to private investment is a long-term strategic decision that should be fully protected from short-term political and economic expediencies.

Mexico is reasonably protected from falling oil prices. However, as a large oil producer and exporter it benefits from higher and more stable prices. The opening of its oil industry to private investment should not be affected by short-term prices and the introduction of competition will benefit from the support given by low oil product and natural gas prices that have allowed for an early elimination of price subsidies.