Economic Analysis

How do we tackle the Pemex situation?

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Recently, especially in the aftermath of Fitch downgrading Pemex's rating from BBB+ to BBB-, there has been nervousness in the markets because Pemex's situation is perceived as a significant risk to the country's macroeconomic stability.

This is because, if Fitch or Moody's lower Pemex's rating by one more grade, Pemex would then be ranked under the so-called investment grade. This would have serious consequences because a significant percentage of Pemex bondholders would be forced by internal rules or regulations to liquidate their position, which would in turn result in the price of these bonds falling. This would not only lead to a loss of confidence toward Mexico, but would also disrupt the Mexican financial system.

To mitigate this risk, the government announced that it will support Pemex with USD 3.6 billion (in addition to its mission to reduce fuel theft by USD 1.6 billion). Although this is a step in the right direction and, for the meantime, prevents Pemex's rating from lowering, it is not enough and will not halt the fall in oil production.

The government is facing a considerable challenge. The more support the government grants to Pemex to strengthen its balance sheet and therefore decrease the possibility its credit rating being reduced, the more pressure is put on public finances, which could eventually result in the sovereign rating being lowered. How can we tackle this challenge?

I believe that the first objective must be to prevent a fall in Pemex's rating and thereby prevent the negative impact to the financial system and to credibility among investors. To do so, the company's capital would need to be increased and its tax burden lowered. This is the main reason as to why Pemex is losing money (in 2018, it will have lost around MXN 80 billion). Even with all the problems the company faces, if its tax burden were 30% (the corporate rate in Mexico) instead of the 70% that it currently is, Pemex would achieve a positive return. Such supports are either financed by reducing public spending or by increasing tax collection (which seems very complicated in the short term considering that the President has announced that taxes will not increase in the next three years) or by a greater fiscal deficit.

All in all, I think it is better to put pressure on Mexico's sovereign rating than to allow Pemex's rating to fall. The country's rating is two grades above the investment grade and, in any case, the markets now rank Mexico—in terms of the cost of its debt—as if it were rated BBB- and not its current BBB+. Given the choice, under these circumstances, it is best that the country's rating fall rather than that of Pemex.

Having said that, the government's capacity to support Pemex and resolve its problems is limited as a result of its small fiscal margin. I think that adopting structural measures to improve Pemex's long-term prospects is feasible and beneficial, and would also substantially reduce the possibility of losing the investment grade, all without putting pressure on public finances. How? I believe that three strategies should be adopted: i) minimize the planned investment in oil refinery: Pemex loses around MXN 100 billion a year in this activity, which exhibits low margins globally.

It is better to focus efforts on oil exploration and production in shallow waters; and, most importantly, ii) partnerships with private companies (farmouts) must be resumed as soon as possible. This would lead to investments that neither Pemex nor the government can provide and constitutes the only realistic option to halt the fall in oil production; and iii) announce a plan to gradually and credibly reduce Pemex's tax burden.

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