LatAm

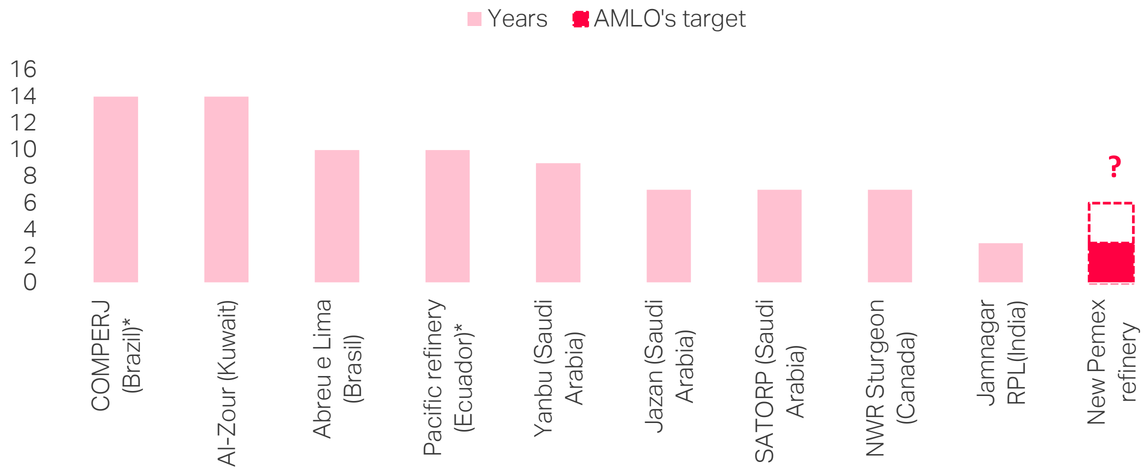
MEXICO: SHIFTING PEMEX RISK

Grace Fan

- **The government's latest moves to aid Pemex have given the struggling firm fresh fiscal relief, but fall far short of mitigating risks for its new USD8+ bn refinery**
- **Still, as the Energy Ministry forges on with its unrealistic formula to make Pemex 'great' again, risk is being recalibrated between the government and the firm**
- **In another blast from the past, state utility CFE's expansion plan rejects privatizations and aims to fund new power projects via off-balance sheet debt**
- **On a more positive note, top US and Mexican officials say they could be close to a deal to lift US steel tariffs, after Mexican tomatoes entered the fray last week**
- **Early Q1 FDI data also surprised on the upside, but AMLO continues to badger private firms to do his bidding, including billionaire Carlos Slim's businesses**
- **Following legislative passage last week, the President signed the education counter-reform into law; this moves the battle to the secondary legislation**

Key global refinery projects

Yrs to build



*Projects have been suspended for years due to lack of financing, corruption and other issues.
Sources: IMCO, local press reports.

Energy

Top issues	Comment	Expected market impact
AMLO vows Pemex's new USD8+ bn refinery will be built, even after global firms say govt budget and timeline are unrealistic	President Andrés Manuel López Obrador (AMLO) last Thurs (9 May) cancelled a tender for Pemex's new 340,000 bbl/d refinery after the bids of global engineering firms came in 25-50% over the planned budget and with far longer timelines than the 3-year target for its construction; now Pemex and the Energy Ministry will manage the project on their own, which will be officially 'launched' on 2 Jun.	Negative (see Chart 1); yet while ratings agencies have warned this raises a red flag for Pemex, actual spending could be slow to materialize, as the lack of technical studies will delay refinery work
Govt officials mull dividing refinery project into two phases, but AMLO rebuffs plan for now	Under the plan, a unit of 170,000 bbl/d could be built in a 1st phase, after which a 2nd unit would follow if funding permits. But AMLO has rejected this idea for now, even though Pemex last built a refinery 4 decades ago and its refining output has plunged (Chart 2).	Neutral to negative; AMLO's vision of a new mega-refinery in his home state of Tabasco is the biggest hurdle to a more fiscally viable plan
Latest govt aid package for Pemex offers the struggling firm more breathing room	The new measures, unveiled Mon (13 May), include: 1) a USD8 bn syndicated loan from JP Morgan, HSBC and Mizuho Securities, of which USD2.5 bn will refinance existing debt and USD5.5 bn will be used to extend existing revolving credit lines with a lower interest rate and longer loan term (5 yrs vs 3 yrs); and 2) tax relief on select mature fields to allow for more capital deductions, freeing up MXN25-30 bn in new tax credits for Pemex in 2019.	While a step in the right direction, the measures are palliative and the firm's structural problems will continue to deepen in the context of insufficient E&P investments and the ongoing freeze of energy reform
More tax cuts for Pemex are forthcoming, but a federal rainy day fund will no longer be tapped	Top Finance Ministry and Pemex's CEO also said this week that more gradual tax cuts for Pemex, to be spread over 2020-24, will soon be announced, while AMLO added this Thurs that a previous fiscal aid plan – a MXN100 bn injection to Pemex from a budget stabilization fund (FEIP) – has been scotched. The new tax cuts will be sent to the Congress in Sept as part of the 2020 budget legislation; in return, Finance Ministry Urzúa has asked for a "convincing" Pemex business plan, which should be approved by Jun or Jul.	Positive for Pemex bondholders, but the firm's structural woes are unlikely to go away without a big change in energy policy; as fiscal risk migrates from the firm to the government, this will buy Pemex time but also boost the odds of sovereign ratings downgrades
Eschewing privatizations, state utility CFE unveils new power generation expansion plan, to be financed by off-balance sheet debt	Following the recent cancellation of power tenders to the private sector and blackouts on the Yucatán Peninsula, the CFE has finally launched a new plan to build 17 priority generation projects totalling USD8.4 bn in investments and 8.8GW of capacity; but it aims to fund at least 12 of the plants via a pre-energy reform, off-balance sheet scheme (Pidiregas) in which private firms will build the plants and the CFE will issue debt or create a trust to pay for it upon delivery.	Negative if the plan is carried out, as the government will be saddled with more debt even if the fiscal impact is deferred; still, it remains to be seen whether Finance Minister Urzúa will give the green light for implementation

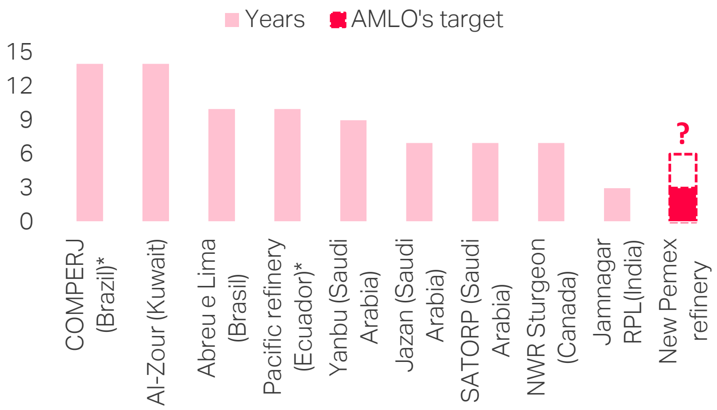
Politics

Top issues	Comment	Expected market impact
Top US, Mexico officials say a deal on lifting US steel tariffs is close	Stoking market hopes, Mexican Economy Minister Márquez and US Treasury Secretary Mnuchin both sounded upbeat this week about closing a deal soon on the lifting of US steel/aluminium tariffs, without a new quota system; yet Márquez warned too that new tariffs on US goods may be imposed in 2-3 weeks if a deal stalls. The progress came after the re-imposition of a long-suspended US tariff on Mexico tomatoes of 17.5%, which could add USD350 mn/yr in costs for Mexican growers if no new deal is struck.	Positive, as it would remove a key obstacle to NAFTA 2.0 (USMCA) ratification; still, while we anticipated progress on this front, USMCA ratification this year is not our base case
AMLO takes aim at billionaire Carlos Slim's firms, airs plan for new state telecom firm	After berating natural gas pipeline firms and retail gas stations for excessively high prices, AMLO in recent days has targeted Slim's firms in the telecom (América Móvil) and construction sectors (Grupo Carso), criticizing poor Internet coverage in remote towns and roadwork delays in Puerto Vallarta.	Negative if it extends beyond rhetoric – notably AMLO's plan to create a new state firm to plug gaps in Internet coverage nationwide
Education counter-reform becomes law	After passing the Congress last week and a majority of state legislatures, AMLO signed the bill into law on Wed; the battle now moves to the secondary legislation, where key details will be hammered out.	Neutral, but teachers' union CNTE is planning more strikes, which may add to disruptions

Economics

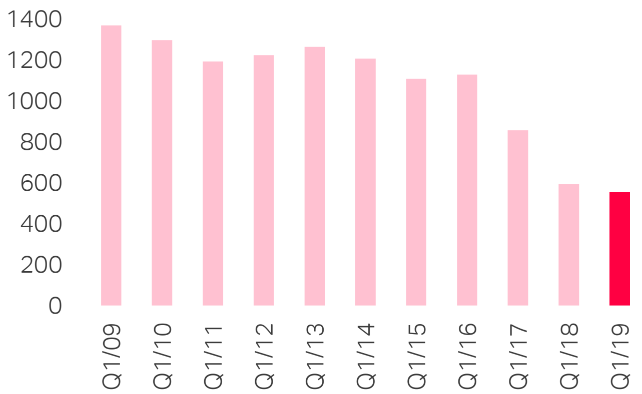
Top issues	Comment	Expected market impact
Amid mixed economic data, Banxico keeps rates level this Thurs	A positive surprise amid tepid economic data came from early Q1/19 FDI, +7% yoy, to USD10.2 bn despite falling investor confidence (Charts 3-8).	Neutral, but Banxico's hawkish tone confirms a rate cut isn't imminent

Chart 1: Key global refinery projects
Yrs to build



*Projects have been suspended for years due to lack of financing, corruption and other issues.
Sources: IMCO, local press reports.

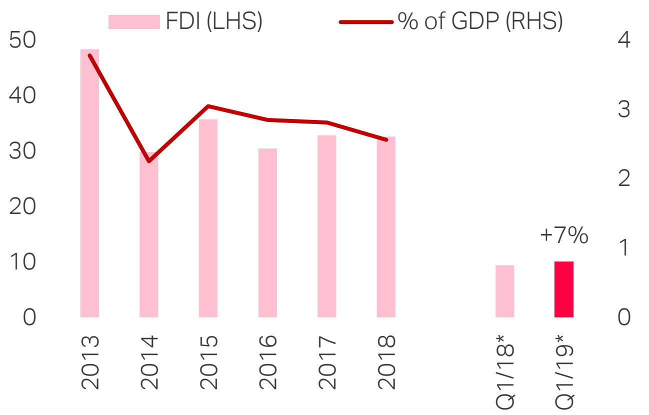
Chart 2: Pemex's refining output in Q1
Mbpd



Source: Pemex.

Chart 3: FDI (net inflows)

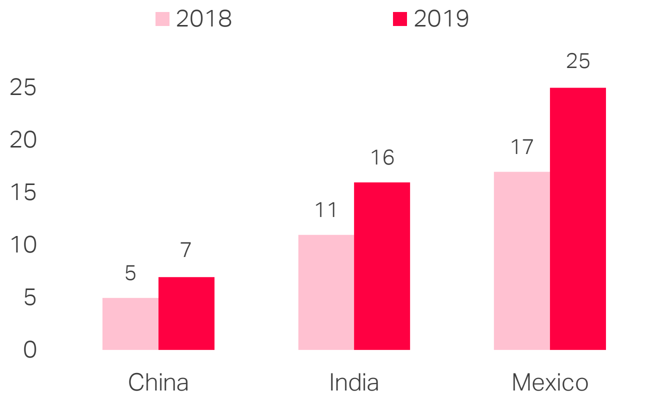
USD bn (LHS) / % (RHS)



*Preliminary data.
Source: Economy Ministry.

Chart 4: Mexico has dropped 8 ranks in a 2019 FDI confidence index*

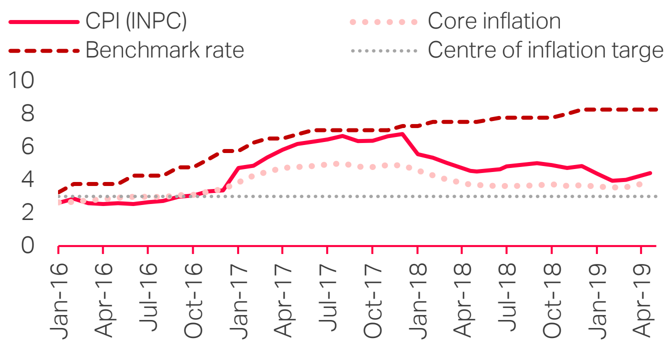
Top 25 index: 1=highest, 25=lowest



*Mexico was one of three emerging markets that made the Top 25 ranking; while Brazil ranked 25th in 2018, it fell off the index this year.
Source: A.T. Kearney.

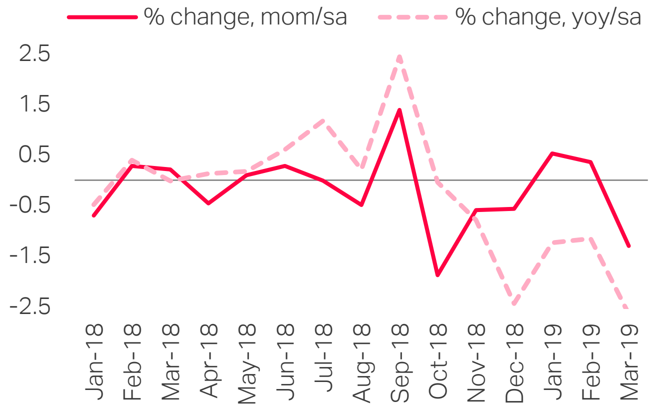
Chart 5: As expected, Banxico kept the key rate flat this week

%



Sources: Banxico, INEGI.

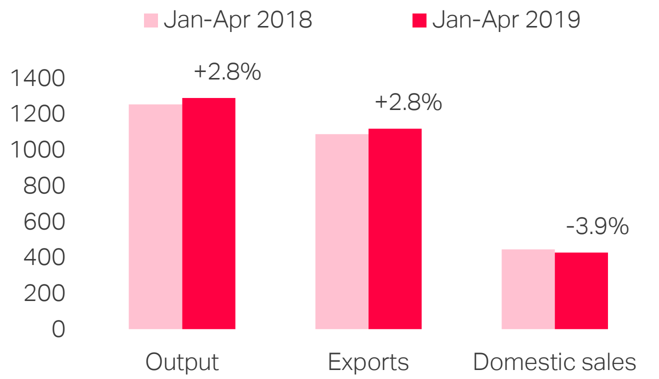
Chart 6: Industrial output fell in March



Source: INEGI.

Chart 7: Auto output and exports are growing, but not domestic sales

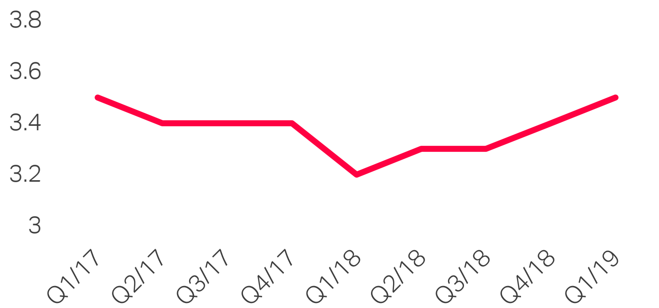
Thousand units (light vehicles)



Sources: AMIA, INEGI.

Chart 8: Unemployment is at a two-year high*

%, sa



*Tabasco, AMLO's home state where the new refinery will be built, has the highest unemployment rate of all the states at 7.4%, sa, in Q1/19.
Source: INEGI.

Authors

Grace Fan
Senior Director, Latin America Research