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## Latin America: Brazil and Mexico's oil industries – opposite policies?

In the context of a global oil market that is likely to remain volatile (**Chart 2**), the two largest Latin American economies – Brazil and Mexico – are expected to implement significant changes in their energy policies in the medium term. Both countries have appointed new presidents in the last year following polarised elections: in Brazil the right-wing president Jair Bolsonaro took office in January 2019, while December 2018 saw the arrival of left-wing André Manuel Lopez Obrador (AMLO)<sup>1</sup>. Similarly, the two oil industries share two main common features: their state-owned companies have experienced significant financial and governance issues, and both countries are crude oil exporters and net oil derivative importers. Conversely, in terms of energy policies, they appear to be taking opposite directions.

In Mexico, AMLO – a fervent critic of the 2013 energy reform that opened the energy market to private investment – appears to be taking a more defensive stance towards the private sector as far as the oil industry is concerned. Since he has taken office, AMLO has suspended new oil tenders for three years. He also plans to reduce the country's reliance on imported oil derivatives by constructing a new refinery, and to increase the role of the state-owned oil company Pemex in the sector, despite its alarming leverage level. The 14-year downward trend in oil production might not be reverted and the financial stress already faced by Pemex might not be contained. As a consequence, the company's credit quality ratings were downgraded by ratings agencies this year.

On the other hand, in Brazil, the new government's plans for the oil industry could lead to a brighter outlook for the sector. The Resilience Plan released by the state-owned oil company Petrobras in early March 2019 aims to improve the company's financial health as well as the perspectives of the Brazilian oil industry. The plan is structured in three pillars: the expansion of the divestment plan in assets in which Petrobras is not a natural owner (which means focusing in exploring what the company knows how to do well), cost reduction, and the reallocation for more productive uses. These measures should help Petrobras further deleverage, and should also improve the value generation of the company's investments while creating opportunities for private investors.

1 - Regarding the political spectrum, political academic researchers consider Mr Bolsonaro as belonging to the far-right and AMLO to the far-left  
Far-right: Hunter, W. and Power, T. Bolsonaro and Brazil's Illiberal Backlash, *Journal of Democracy*, Johns Hopkins University Press, Volume 30, Number 1, January 2019  
Far-left: McClintock, C. Reevaluating Runoffs in Latin America, *Journal of Democracy*, Johns Hopkins University Press, Volume 29, Number 1, January 2018

## The sector has faced challenges in the two economies in recent years

The oil industry in Brazil has gone through big changes since 2014, when state owned oil company Petrobras was involved in a large corruption investigation (Operation Carwash<sup>2</sup>) that led to the arrest of high-profile politicians as well as businessmen from the state-run company and from major domestic private-owned conglomerates. Nonetheless, since the mandate of President Michel Temer (2016-2018) with a new management in Petrobras, the executive team has assumed a more pro-market direction. For instance, subsidies on oil derivatives prices were removed (favoring competition in fuel distribution), local content rules were smoothed and the mandatory requirement of 30% participation of Petrobras fields was abolished<sup>3</sup>. Alongside, the company has also implemented a divestment plan of non/low-profitable assets, in order to reduce high indebtedness. After four years of losses, Petrobras registered in 2018 a net profit of roughly USD 6.9 billion and an adjusted EBITDA<sup>4</sup> of USD 30.7 billion, which represents an increase of 50% over 2017. Moreover, gross debt had also fallen from USD 126.3 billion in 2015 to USD 84.4 billion last year. As a result, the company reduced the net debt to Adjusted EBITDA ratio to roughly 2, down from nearly 4 registered in Q4 2017 and lower than the target of 2.5 established for 2018.

In Mexico, the last decade was not any less challenging, notably when it comes to oil production. Although

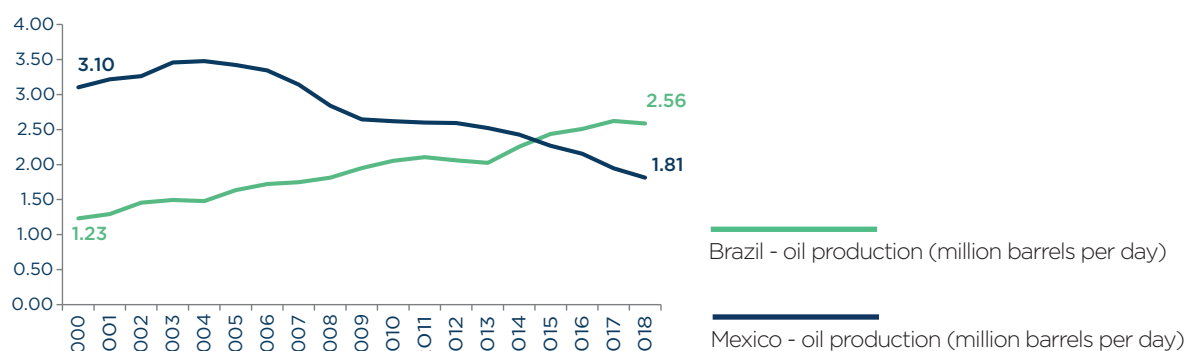
Brazilian oil production increased by 75% between 2004 and 2018, in large part due to the pre-salt oil fields<sup>3</sup>, Mexican production has steadily declined (-48%, **Chart 1**). At the same time, the poor performance registered by Mexico can be explained by the lack of investments and access to cutting-edge technologies as a result of nearly 80 years of monopoly by Pemex. This monopoly lasted until end 2013, when the government of President Peña Nieto (2012-2018) was able to get approval in Congress for a landmark energy reform opening the market for private companies. Although the timing was not ideal (oil prices started to plunge in mid-2014), contracts have been awarded to a range of private and foreign firms, such as oil majors Royal Dutch Shell and Chevron. Nevertheless, as investments in this industry take time to mature, the benefits of the reform are not yet visible. It is also worth noting that Pemex has long been perceived as Mexico's "cash cow": a high percentage of Pemex's pretax profits goes to the government (higher than even Venezuela's state owned oil company PDVSA)<sup>5</sup>. Additionally, the recent financial performance of Pemex also lags behind that of its Brazilian peer. Pemex has increasingly relied on issuing debt and is understood to currently be among the most heavily-indebted oil companies in the world, with an estimated debt of USD 106 billion at the end of 2018 (as well as approximately USD 70 billion in social security obligations)<sup>6</sup>. Nearly a third of Pemex's debt is due in the next three years.

**TABLE 1**  
Oil in Brazil and Mexico – Key facts

Main features	Brazil	Mexico
Position in the global oil production ranking (2017)	9 <sup>th</sup>	11 <sup>th</sup>
Ranking in terms of oil production in Latin America (2017)	1 <sup>th</sup>	2 <sup>nd</sup>
Position in the main oil consumer ranking (2017)	7 <sup>th</sup>	12 <sup>th</sup>
End of public monopoly	1995	2013
Accumulated foreign direct investment in the energy sector between 2014 & 2018	USD 20 billion	USD 5.5 billion

Sources: EIA, Central banks

**CHART 1**  
Evolution of oil production in Mexico and Brazil



Sources: ANP, Pemex and EIA

2 - For more details, please consult Krause, P. Political Risk in Latin America: Back to the Future?, Coface May 2018 <https://www.coface.com/News-Publications/Publications/Political-Risk-in-Latin-America-Back-to-the-future>

3 - The Brazilian pre-salt oil region, first explored in 2006 by Petrobras, is an oil-rich offshore reserve in depth of 7000 meters;

4 - Earnings Before Interest, Taxes, Depreciation, and Amortization. The net debt to EBITDA ratio (debt/EBITDA) gives an indication as to how long a company would need to operate at its current level to pay off all its debt.

5 - Stillman A. How Pemex became the most indebted oil company in the world. 26 February, 2019. Bloomberg. Available at: <https://www.bloomberg.com/news/articles/2019-02-26/how-pemex-became-the-most-indebted-oil-company-in-the-world>

6 - Eschenbacher, S. Mexico president's Pemex plans rattle faith of debt holders. 11 December 2018. CNBC. Available at: <https://www.cnbc.com/2018/12/11/reuters-america-mexico-presidents-pemex-plans-rattle-faith-of-debt-holders.html>

**Brazil and Mexico are both crude oil exporters and net oil importers...**

In terms of trade balance, both countries are net crude oil exporters and net oil derivative importers. Nevertheless, while Brazil has been able to improve its trade balance in the sector, Mexico has suffered the opposite due to collapsing oil production and higher demand for oil derivative imports. It is also worth noting that, in theory, the discoveries in the pre-salt fields made Brazil self-sufficient in oil production. In practice, however, the country depends on the import of oil and oil products.

**...notably because the majority of oil extracted is a heavy type of oil**

The oil extracted in Latin America is predominantly of the heavy type. Brazilian oil is principally of the heavy and medium types, which are more dense and difficult to refine. Brazilian refineries need to mix domestic heavy oil with imported light<sup>7</sup> oil to refine it. Furthermore, the oil produced in both Brazil and Mexico comes mainly from offshore basins, which require higher investments for extraction. Offshore crude oil production represents respectively 95% and 79% of Brazil and Mexico's total oil production.

**What will be the consequences of each country's energy policy?**

2018 was marked by volatility in the oil global market due to various factors, with supply being affected by the US sanctions imposed on Iran and Venezuela, and demand suffering from worries around the impact of a trade war, as well as the consequences of the past economic cycle peak (Chart 2). Concerned about declining oil prices, the OPEC+<sup>8</sup> agreed in December 2018 to implement new production cuts in 2019 (cuts of 1.2 million barrels per day over the first half of 2019). For 2019, Coface estimates Brent crude oil price to average USD 65, as the uncertainties that prevailed in 2018 are not expected to dissipate this year, while prices are likely to be capped by a slowdown in a majority of economies, as well as an increasing US supply.

The energy policies of both countries will be in the spotlight, as they are strategic sectors that formed a key part of each recently-elected president's election campaigns. The main plans of those policies (Table 2) will have to be implemented in a context of a very volatile oil market.

Brazil's oil policy is expected to have a positive knock-on effect on the sector for the years to come, with oil production looking likely to increase. In its March 2019

**TABLE 2**  
Short- and medium-term plans for Brazil and Mexico's respective energy policies

Brazil	Mexico
<ul style="list-style-type: none"> <li>Reduction of operational costs: cut of 6.6% from the total amount of USD 122.6 billion budgeted in the 2019-2023 investment plan<sup>9</sup></li> </ul>	<ul style="list-style-type: none"> <li>Suspension of new oil tenders for three years</li> </ul>
<ul style="list-style-type: none"> <li>Expansion of the divestments of assets program: inclusion of more mature fields of oil and gas in land and in shallow waters</li> </ul>	<ul style="list-style-type: none"> <li>Boost domestic production of fuels to curb dependence on imports: construction of a new USD 8 billion refinery operated by PEMEX<sup>10</sup> / existing six plants revitalization.</li> </ul>
<ul style="list-style-type: none"> <li>Fuel prices: pegged to international parity maintained</li> </ul>	<ul style="list-style-type: none"> <li>Free market scheme for oil prices to be broadly maintained</li> </ul>
<ul style="list-style-type: none"> <li>Focus investments on the assets in which Petrobras is a natural owner (ultra deep-water oil exploration and production, including pre-salt)</li> </ul>	<ul style="list-style-type: none"> <li>Pemex will develop 20 new fields in 2019 (16 offshore and 4 onshore); focus on shallow water and conventional onshore projects (lower production costs and faster development)</li> </ul>
<ul style="list-style-type: none"> <li>Chunk of Petrobras refinery activity (currently 98%) to move to the private sector</li> </ul>	<ul style="list-style-type: none"> <li>Pemex to remain state owned : Aid package for Pemex of USD 5.2 billion</li> </ul>
<ul style="list-style-type: none"> <li>Petrobras to remain state-owned, though subsidiaries could be sold</li> </ul>	

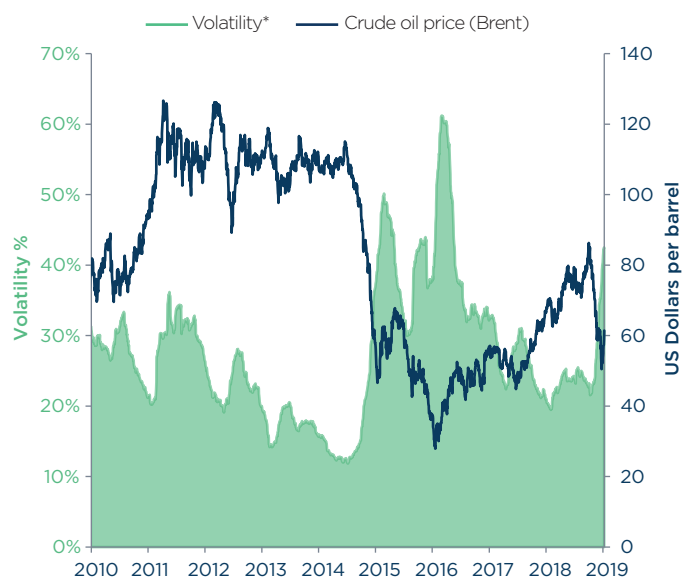
7 - Light crude oil is liquid petroleum that has a low density and flows freely at room temperature, while heavy crude oil is highly-viscous oil that cannot easily flow to production wells under normal reservoir conditions.  
8 - OPEC+ comprises the OPEC members plus partners participating in the agreement. OPEC members: Algeria, Angola, Congo (Republic of), Ecuador, Equatorial Guinea, Gabon, Iraq, Iran, Kuwait, Libya, Nigeria, Saudi Arabia, United Arab Emirates (UAE), Venezuela. Nigeria and Libya are exempt from the agreement due to known production disruptions in 2016. OPEC partners: Azerbaijan, Bahrain, Brunei, Kazakhstan, Malaysia, Mexico, Oman, Russia, Sudan, Southern Sudan.  
9 - In December 2018, Petrobras announced investment plan for the period of 2019-2023. Under the new plan, the company aims to invest USD 84.1 billion in the upcoming years.  
10 - The invitation to the bid on the new refinery construction will be restricted to four firms.

report, OPEC noted that Brazil will boast the second-largest increase in annual oil output within the non-OPEC camp in 2019, adding 360,000 barrels per day (bpd), only behind US shale. In terms of Petrobras' financial health, the company seems to be reducing its leverage level and improving profitability. In fact recently, rating agencies Standard & Poor's and Fitch have both

improved Petrobras' credit risk on a stand-alone basis from bb- to bb and BB- to BB+, respectively. It is worth noting, however, that the new business strategy of Petrobras is not totally immune to discontent. Some sector specialists have argued that the strategy is distancing from business that have been drawing attention from its global peers (such as petrochemicals and renewable energy).

The scenario for the energy sector in Mexico seems indeed cloudier. Under a six-year business plan, Pemex's goal is to raise production to 2.48 million bpd by the end of 2024. The aforementioned projection appears unrealistic, given the huge level of investment required to revert the declining tendency in oil production. The international ratings agency Fitch Ratings<sup>11</sup> cited that the company would need an investment between USD 12-17 billion for Pemex to halt declines in production and reserve levels (roughly 1.2% of Mexico's GDP). Moreover, the government's decision on constructing an expensive refinery to curb dependence on imported US fuel is questionable, as refining in Mexico is a less profitable operation than oil exports. There is also an increasing fear among the market that current energy policy could jeopardize the company fiscal balance, putting at risk also the country's sovereign one. All in all, the maintenance of fiscal discipline, with the recovery of Pemex's financial health and the strategy of having the company as the protagonist of energy policy, seems like an equation that will be difficult to solve.

**CHART 2**  
Crude oil price volatility



\* Volatility is estimated using the Yang and Zhang (2000) estimator with a rolling window of 63 days (one quarter). The sample period is January 1, 2010 to January 9, 2019.  
\* Volatility of crude oil price. The sample period from January 1, 2010 to March 27, 2019. Last oil data point is March 27, 2019

Sources: Datastream, Coface calculation

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<sup>11</sup> - Fitch Ratings. Fitch Baja Calificación de PEMEX a 'AA(mex)'; Perspectiva Negativa. January 29, 2019. Available at: <https://www.fitchratings.com/site/pr/10060977>

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