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Slower Mexican Reforms Threaten U.S. Refiners

AMLO government emphasizes self-sufficiency.

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U.S. Energy Information Administration
SENER
To discover more about the data sources used, click here.

Reliance on U.S. Refined Products

The July 2 election of Andrés Manuel López Obrador—known universally as AMLO—to the presidency, has thrown into question the progress of energy market reforms in Mexico after he takes office in December. The reforms, dating back to 2013, encouraged significant overseas investment in the upstream, midstream, and downstream sectors of Mexico's oil industry. A good portion of these investments boost Mexico's reliance on imports of U.S. refined products to meet growing domestic demand and declining local output. AMLO's statements so far indicate plans to increase investment in PEMEX, the former state monopoly, and stress self-sufficiency over imports and outside investment. This note discusses the consequences for U.S. midstream and refining companies if Mexico's new president slows down or halts the reform process.

Initial Plans

At the end of July, AMLO revealed his initial energy policies at a press conference. These included ambitious plans for Mexico's refining sector and reversing the country's 15-year-long decline in crude production. These policies earmarked investment in PEMEX, including $4 billion in additional upstream investment to boost crude output, $2.6 billion over two years to upgrade six existing refineries, and work on a new refinery at the oil port of Dos Bocas in Tabasco state costing $8.6 billion over three years. AMLO has also said he will review over 100 exploration and production contracts won by private companies since 2013. Although these indications suggest a radically different approach to that of his predecessor Enrique Peña Nieto, who initiated energy market reforms in 2013, analysts agree that the constitutional changes that the reforms required will be difficult to reverse.

Reform Progress

As we explained in our November 2016 note "Sailing Around The Wall? U.S. Refined Product Exports to Mexico," Mexico's energy market reform law, enacted in December 2013, ended national oil company Pemex's monopoly over the oil and gas sector. In the downstream refining and marketing sector, that has meant opportunity for outside investment in Pemex refinery projects, as well as outside access to Pemex storage and pipeline logistics assets. Starting in 2017, energy regulator CRE also began to liberalize prices previously set by the government, so that overseas suppliers could operate profitably. We described the frenzy of infrastructure development under way to prepare Mexico's domestic refined products distribution system for ongoing market reforms in a January 2017 note (see "U.S. Equity Builds Out Mexico's New Competitive Infrastructure").

Given that Mexico is a close neighbor, a fellow member of NAFTA, and a large importer of U.S. refined products, it's no surprise that the energy market reforms are a big deal for U.S. refining and midstream companies. We described the opening of Mexico's downstream transport fuel infrastructure to outside competition in a May 2017 note (see "Mexican Downstream Opportunity for U.S. Refiners"). We've detailed individual company investments south of the border including ExxonMobil (see our March 2017 note "ExxonMobil Bets on Downstream U.S. Returns") and Marathon and its recent acquisition Andeavor (see our May note "Has Marathon's Refining Empire Hit the Wall?"), as well as plans for smaller refineries in Texas to sell refined product into the Mexican market (see our July note "Can Small Refineries Succeed in North Dakota and Texas?")

What's at Stake?

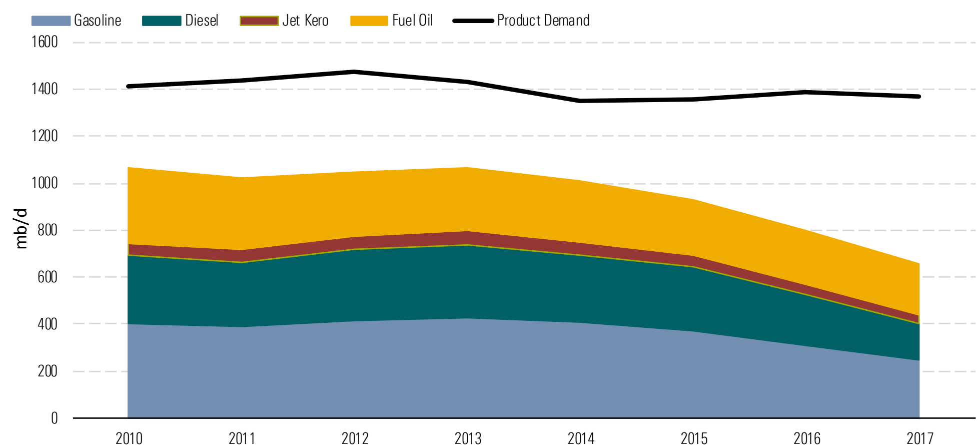
If Mexico's energy market reforms stumble or slow down, existing and promised outside investment estimated by the Mexican Energy ministry, SENER, amounting to $200 billion could be at stake. That investment covers natural gas and power, upstream oil and gas, and refining and distribution. In this analysis, we concentrate on the refining and downstream sector, which is already heavily dependent on U.S. imports.

Refinery Neglect

Mexico has six refineries with nameplate capacity of 1.6 million barrels/day between them. They've been running at less than 70% capacity since 2012 because of maintenance neglect and a lack of investment and upgrading. Combined refinery output of gasoline, diesel, jet kero, and fuel oil fell by 38% between 2010 and 2017 according to SENER (Exhibit 1). Individual production of gasoline fell by 39% and diesel by 47%. Over the same period, overall demand for refined products has remained level at about 1.4 mmb/d (black line in Exhibit 1).

The widening gap between demand and declining domestic output requires PEMEX to import increasing volumes of gasoline, diesel, and jet kero after 2013, most of which (as detailed next) comes from the U.S.

Exhibit 1 Mexican Refinery Operations 2010-17



Source: SENER, Morningstar

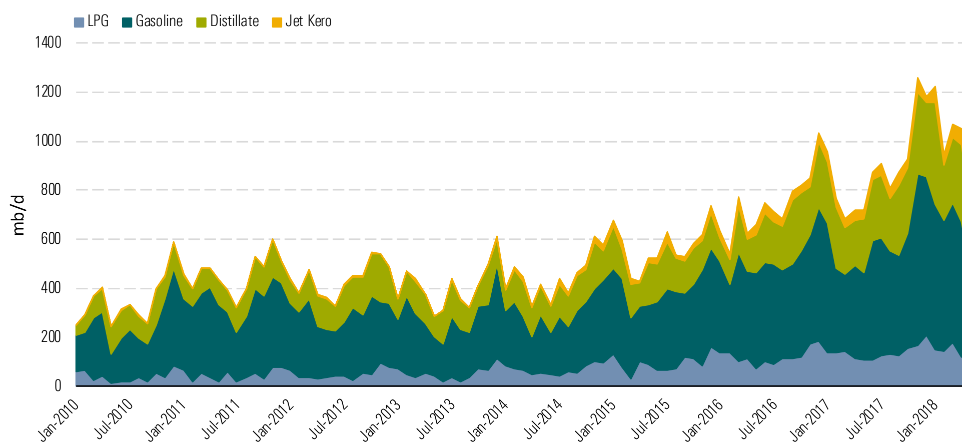
U.S. Reliance

Data from the U.S. Energy Information Administration shows the rapid annual growth of refined product exports to Mexico over the past eight years (Exhibit 2). Between 2010 and 2017, exports of liquid petroleum gases (mostly propane and butane) grew 362% from 38 thousand barrels/day to 137 mb/d. Exports of finished gasoline and gasoline blend components over the same period grew by 216% from 214 mb/d to 482 mb/d. Distillate (mostly diesel) exports grew by 266% from 94 mb/d to 250 mb/d and jet kerosene exports grew 10-fold from 4 mb/d to 40 mb/d. Exports of all these fuels have continued to grow in 2018.

In the process, Mexico has become a key market for U.S. refined product exports, most of which are produced by Gulf Coast refineries, with a smaller volume being shipped from the West Coast. EIA annual figures for 2017 show that Mexico represented 11% of total U.S. LPG exports, 25% of distillate, 26% of jet kero, and a whopping 54% of gasoline.

Mexico is even more heavily reliant on the U.S. as a refined product supplier. According to SENER, PEMEX purchased nearly 100% of its diesel imports from the U.S. in 2017, as well as 81% of its gasoline and over 90% of jet kero.

Exhibit 2 U.S. Refined Product Exports to Mexico



Source: EIA, Morningstar

Investment Benefit

The 2013 Energy Market reforms ended PEMEX's monopoly over oil and gas, which had reduced the incentive to invest in expansion and modernization. The hope was that outside investment would improve the domestic refineries and rapidly expand distribution and retail networks to offer consumers better value and choice. Seeing a growing market, U.S. midstream companies, oil majors, and refiners invested heavily in this process. A great deal of the benefit of this investment is in extending domestic market penetration in Mexico. Instead of selling bulk cargoes of transport fuels to PEMEX under tender agreements, they can now bypass the state monopoly to deliver product directly into the distribution

system, all the way down to retail gas stations. The result is a more stable market share and higher margins.

Consequences

If the new government slams the brakes on outside investment and instead pumps more money into PEMEX refineries to boost domestic production, we see two consequences for U.S. refiners and midstream companies. The first is a slowdown in U.S. investments in port infrastructure, pipelines, terminals, and storage facilities associated with opening the distribution system. The second is a longer-term slowdown in refined product exports to Mexico as the domestic refineries increase the country's self-sufficiency.

Although the nature, timing, and financing of AMLO's proposed changes are not yet clear, there is no denying that consequences for U.S. refiners could be considerable. The expansion of Gulf Coast refining during the shale era is closely bound to growing export demand, with Mexico being the largest customer. Any contraction in that export demand will require a major strategic rethink by U.S. suppliers.

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