

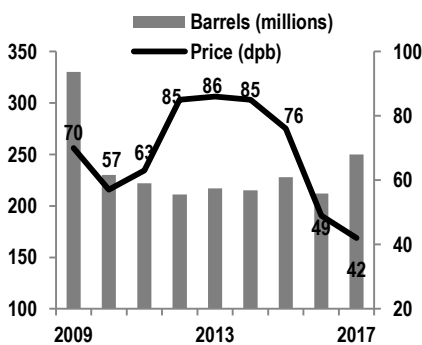
Oil hedge – Shielding government revenues in 2017

- The Ministry of Finance (MoF) announced the government’s oil hedge program for 2017
- The hedging strategy in 2017 covers 250 million of barrels with an average price of 42 USD per barrel (dpb)
- This announcement comes as part of the 2017 economic package, to be published next week
- In addition, the federal government has the resources of the *Oil Stabilization Fund* (FEIP), which amounts to MXN90.2bn (~US\$4.9bn)
- Looking ahead, we expect a favorable outlook for the oil market’s balance but price action will remain in a contained range in the mid-term
- In this context, we consider that the hedging strategy of the government, coupled the budget cuts announced show the government’s commitment with a strong public finances

The Ministry of Finance (MoF) recently announced the government’s oil price coverage program for 2017. This program aims to ensure Mexico’s macroeconomic stability as well as guarantee the government’s revenues next year. The hedging program includes two strategies: (1) The purchase of put options with an average exercise price of 38dpb for the Mexican exporting mix of oil; and (2) to ensure a 42dpb average price in the year in question, the government will close the gap with MXN18.2bn (~US\$984mn) coming from the Oil Stabilization Fund (FEIP).

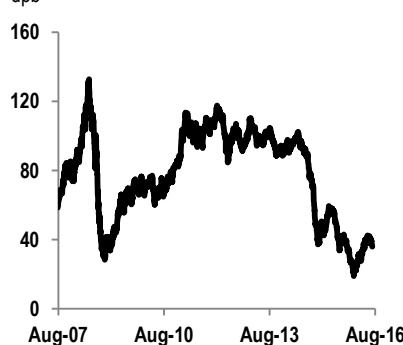
Lower price but higher hedge volume. A total of 46 operations with 7 different counterparts were conducted in international derivatives markets between May and August, 2016. With such operations, 250 million barrels were covered with a cost of around MXN19bn (~US\$1bn). Volume hedged is 38 million barrels higher than last year’s, with an exercise price 16.7% lower than the one obtained by this strategy last year, as shown in the chart below. This reflects the current situation of oil markets, which includes a combination of lower production, as shown in the chart in the far right, but with recovering prices above 40dpb (see chart in the middle).

Oil hedge



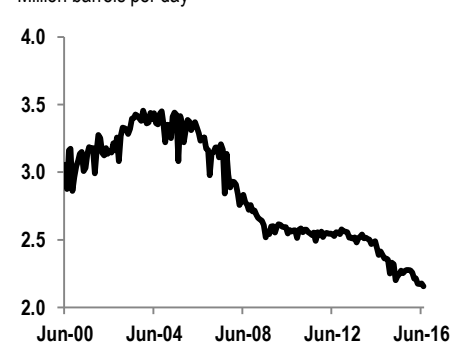
Source: SHCP

Mexican mix of oil



Source: Bloomberg

Oil production platform



Source: SENER

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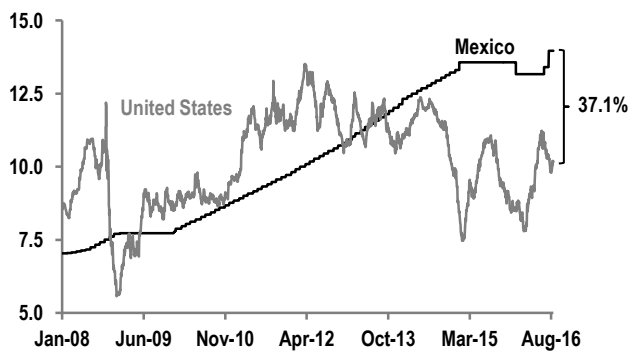
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This announcement comes as part of the 2017 economic package. According to the *Fiscal Responsibility and Budget Law*, the Federal Government must submit before September 8 of each year of the administration, an *Economic Package*, which includes the *Revenue Law*, the project for a *Spending Budget* and the *General Economic Policy Guidelines*. The Lower-House has until October 20 to approve the *Revenue Law*, while the Senate has until October 31 to approve it. In terms of the spending budget, it is reviewed only by the Lower-House, which has until November 15 to approve it.

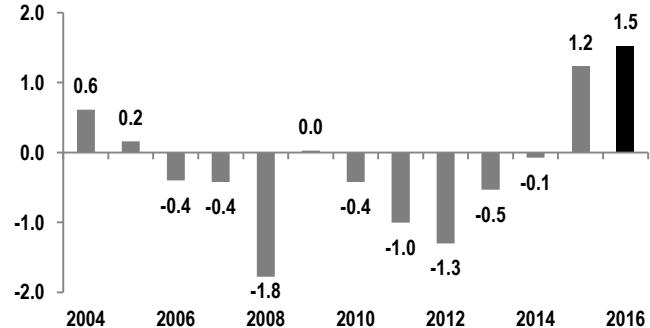
Oil hedging is part of the government’s strategy to shield its revenues next year. In addition, the federal government has the *Oil Stabilization Fund (FEIP)* with 90,239.9 million pesos (~US\$4.9bn) to protect public finances (excluding the MXN18.2bn used to close the price gap mentioned above). Similarly, taking into account the *Infrastructure and the Federal Entities Stabilization Funds*, total resources amount to MXN179.1bn according to the last MoF *Public Finance Report* (including the cost of the hedge). Moreover, Mexico’s exchange rate and the differential price between Mexico’s gasoline prices and the free-market prices partially offset the lower revenues given Mexico’s lower production platform and lower oil prices. Year to date, the price of gasoline in Mexico has been 39.9% higher than the average reference price in the U.S. (refer to the chart on the left) –this differential is currently 37.1%-, which resulted in a positive *IEPS* revenue, as shown in the chart on the right.

Low-grade gasoline price
Pesos per liter



Source: Banorte-Ixe with data from PEMEX and Bloomberg

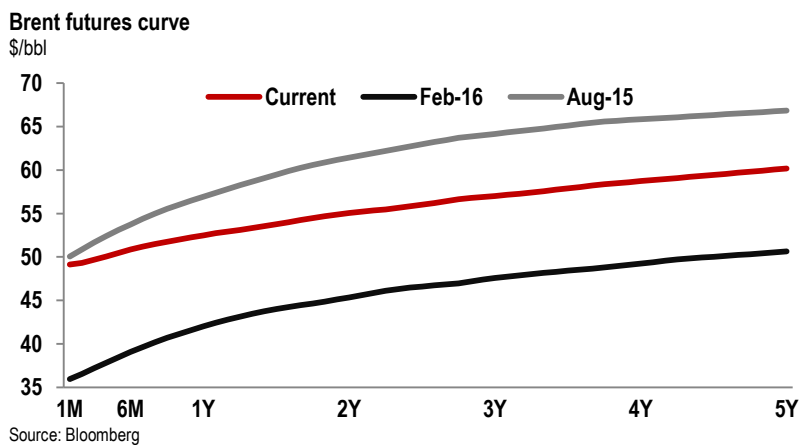
Gasoline IEPS revenues
% of GDP



Source: Banorte Ixe with data from MoF and INEGI

Looking ahead, we expect a favorable outlook for the oil market’s balance but price action will remain in a contained range in the mid-term. Oil prices have stabilized during the last months, mainly after reaching a 12-year low at the beginning of 2016. The latter was a response of an improved outlook for the global demand and supply balance going forward and particularly due to recent disruptions, from which a weaker dollar was added. As a whole, these conditions allowed for an important recovery in prices. Although we expect the rebalancing path to continue this year and into 2017, we believe there are latent risks with the potential to induce new downward corrections, although primarily keeping price ranges contained with a low chance of a strong upward break of the 50 \$/bbl in the short-term for Brent and WTI benchmarks.

Along these risks, we highlight the possible reactivation of higher-cost production (shale) as prices approach a marginal extraction cost around 60 \$/bbl, an improvement in geopolitical conditions that triggered recent supply disruptions (*e.g.* Nigerian infrastructure attacks), higher Iranian and Iraqi production levels, prevailing high inventory and dollar strength. It is worth mentioning expectations have picked up about the possibility of a coordinated action to support prices by OPEC and non-OPEC (Russia) countries through a production freeze. This situation is similar to the Doha’s meeting last April, although this time the framework is an energy forum taking place in September with several energy ministers from different countries happening to assist and agreeing to engage in “informal” meetings. Market participants have been extremely sensitive to headlines on this subject, and for which we believe there is a very small chance of a successful agreement. The following chart shows the Brent futures curve, with a trading level for the contract due on Dec’17 at 53.19 \$/bbl and for Jun’18 at 54.38 \$/bbl. Moreover, it remains in *contango* (lower spot prices *vs.* future contracts) which has prevailed from at least one year ago, with higher levels along the curve *vs.* those in February this year. Currently, the front-end Brent future contract trades at 45.15 \$/bbl.



In our view, oil hedging strategy shows the government's commitment with healthy public finances. One of the pillars of the Mexico’s macroeconomic framework is to maintain the stability of public finances. Given the adverse global backdrop, we consider that the hedging strategy will contribute to reduce some uncertainty to government revenues. Additionally, we highlight the spending cuts announced as part of the overall strategy of the government to will keep public finances under control.

Disclaimer

The information contained in this document is illustrative and informative so it should not be considered as an advice and/or recommendation of any kind. BANORTE is not part of any party or political trend.

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