IS MEXICO UNHEDGED?

Russell Clark's Market Views

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Oil revenue makes up a large but declining share of the Mexican government revenue. Since the 1994 Tequila Crisis, Mexico has hedged forward the price it sells its oil production so that the government does not need to make sudden cuts to government spending. The idea is to reduce macroeconomic volatility. Typically the hedging program buys puts at a strike price below current market prices, and the Mexican government budget is based on this lower price. Usually the hedging program loses money for the government, but occasionally it books huge windfall profits. http://www.ft.com/cms/s/0/ccd87f9e-9bd9-11de-b214-00144feabdc0.html#axzz3Mj4LZZuH

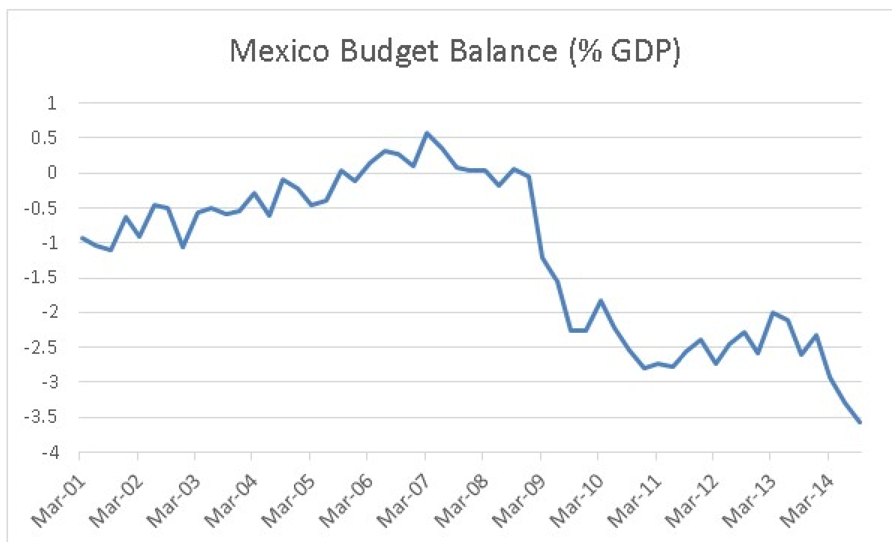
As it is the largest hedging program in the world, the operation is shrouded in secrecy. According to news articles, the program takes place from September to November, after the Mexican budget is approved. Once the hedging program is in place, the government disclose the strike price of the puts, the cost of the program and the barrels of oil that have been hedged. Details of the recent hedging are here: http://www.ft.com/fastft/236352/post-236352

Year	2008	2009	2010	2011	2012	2013	2014
Strike price on puts	70	57	63	85	84.9	85	76.4
Volume	330	230	222	211	200	215	228
Program Cost USD mn	1500	1172	1170	1000	897	543	773
Oil Price - Sept - Nov	90	75	78	110	110	110	85
Oil Vol - Sep to Nov	55	45	30	40	27	20	40
Premium Cost ($ per brl)	4.5	5.1	5.3	4.7	4.5	2.5	3.4

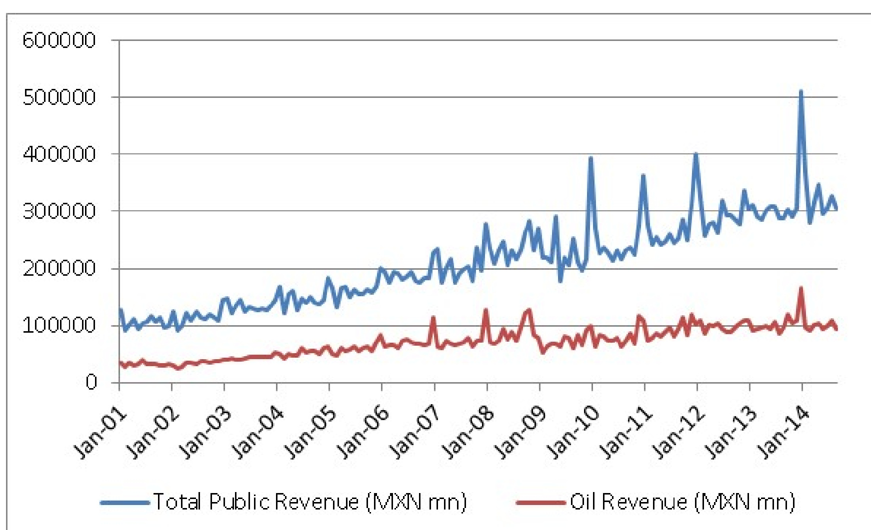
The above data has been taken from FT, Bloomberg and Reuter articles. The premium cost above; is the cost of the program divided by the amount of oil hedged, which gives an idea of the cost of each barrel to buy a put. From 2008 to 2012 the cost of the program was roughly USD 5 a barrel. In other words, Mexico was willing to give up 5 dollars per barrel of oil to guarantee a set amount of revenue.

It is noticeable that in 2013 and 2014, the cost per barrel for hedging declined. The FT reports that this is due to a change in hedging strategy in Mexico. Rather than just buying puts, they now also sell a put at lower price to reduce the cost.
http://www.ft.com/cms/s/0/ab402292-072e-11e2-92b5-00144feabdc0.html#axzz3Mj4LZZuH
This strategy, known as a put spread, means that you are hedged as long as the oil price does not fall below the strike price of the lower put.

As mentioned before, the hedging program is kept secret, so we have no idea of whether the Mexican government has continued using put spreads to hedge its oil production. However, when I look at the premium cost of the recently concluded hedging program, it seems too low given the dramatic fall in oil prices, and big increase in oil volatility, which should make a program like this more expensive. I strongly suspect Mexico has employed a put spread structure, possible with a lower strike at USD 60 or higher. Does this matter?



Mexico has been running a large budget deficit since the financial crisis. While oil revenue still makes up about a third of Government revenue.



Typically the Mexican Peso devalues so that the Peso value of oil revenues do not decline, however the recent fall in oil prices has not been matched by a commensurate fall in the Peso.

If we assume the oil price stays at current levels, which seems reasonable given the pronouncements from Saudi Arabia, then we can make some reasonable conclusions on the Mexican Peso. Given the already large fiscal deficit in Mexico, the Peso would need to devalue to restore the oil price to 1400 in Mexican Peso terms. 1400 oil in Peso terms implies an exchange rate of 25 at a Brent price of USD 55. The Peso trades at nearly 15 today. The risk reward of shorting the Mexican Peso looks attractive to me.

INFORMATION

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