Pemex

Mexico, Oil & Gas

Accounting		Climate Assumptions		Audit		Date of analysis: 24th May 2021
Judgements	Consistency with other reporting	Visibility	Paris alignment	Visibility in CAMs	Consistency check	Year end: 31st December 2020 Report date: 17th May 2021 AGM: n.a.
						CA 100+ company, so seen by investors as key to driving global net zero emissions
Significant concerns	Significant concerns	Some concerns	Significant concerns	Significant concerns	Significant concerns	

Summary view:

- The narrative reporting in the 20-F rightly identifies that climate change is a major risk factor for Pemex, with the energy transition expected to make a significant impact future demand and pricing for crude oil, while operating assets may be adversely affected by extreme weather events resulting from climate change.
- However, despite the identification of these risks – and Mexico's commitment to reduce emissions as a signatory of the Paris Agreement – climate change is not reflected in the corporate strategy, with a large increase in CAPEX for crude oil exploration and production. Climate considerations do not appear to be reflected in the audited financial statements in any way.

Background

<u>The Business</u>

- Petróleos Mexicanos, commonly known as Pemex, is the Mexican state-owned national oil company. It is the eleventh largest crude oil producer in the world and the largest company in Mexico by revenues. Taxes on Pemex provide approximately one third of all tax revenues collected by the Mexican government.
- Pemex has three operating segments: Pemex Exploration & Production; Pemex Industrial Transformation, which includes refining and petrochemicals; and Pemex Logistica, including pipelines, transportation and storage. Pemex only operates in Mexican territory, with most production offshore in the Gulf of Mexico, but also large quantities onshore in the south-eastern and north-eastern states. In 2020, Pemex's total hydrocarbon production was 884 million barrels of oil equivalent.
- Pemex is a wholly state-owned entity under the Mexican government. It is not a corporation and does not have shareholders. However, Pemex is a major issuer of corporate bonds, including debt securities registered pursuant to the US Securities Act 1933, which are also listed on the Luxembourg Stock Exchange.
- The 2021 CAPEX budget amounts to Ps.194 billion (approximately US$10 billion), marking a 59% increase from the Ps.122 billion actual capital expenditures in 2020. Despite the company's acknowledgement of climate risks, 92% of the 2021 CAPEX budget is allocated to Exploration and Production, where Pemex aims to reverse the decline in reserves and production and accelerate the development of discovered fields. The company intends to reallocate resources away from deep-water projects, which are expensive, long-term investments, and towards shallow water and onshore projects, with nearer-term payback. Pemex is also constructing a seventh refining complex in the state of Tabasco.
- The consolidated financial statements were prepared assuming Pemex will continue as a going concern, but the notes to the financial statements state that there is significant doubt about the company's ability to continue as a going concern. Pemex has incurred substantial debt, mainly to finance the CAPEX for capital investment projects, which cannot be funded from operating cash flows due the heavy fiscal burden of extraction duties and other taxes owed to the Mexican government. The company's net losses increased to Ps.509 billion (approximately US$26 billion) in 2020 while the accumulated negative equity continued to grow. In early 2020, Pemex's bonds were downgraded from investment grade to sub-investment grade. The Mexican government has committed to inject funds into the company, with Ps.109 billion in capital contributions in the first four months of 2021.

- Pemex also identified material weaknesses in internal control over financial reporting for each of the last five years and has concluded that the internal control over financial reporting was not effective on 31st December 2020.
- The narrative reporting in the 20-F states that Pemex's operations generated 54.0 million tons of carbon dioxide equivalent in 2020. This marked a 12.5% increase from the previous year due to: (i) increased exploration and production activities; (ii) increased gas flaring due to maintenance and unscheduled shutdowns; (iii) the inability to use gas recovered in the production process due to failures in compression systems and (iv) maintenance to productive refining equipment. It is not clear what is included in this simplistic disclosure of CO2 emissions, although there may be more detail forthcoming in a separate Sustainability Report.
- Pemex faces material climate risks, both from the transition from hydrocarbons, especially oil, to alternatives fuels and from physical risk as extreme weather events impact fixed assets including offshore operations. Pemex produces large quantities of heavy sour crude, which raises additional environmental concerns as it is used to produce fuel oil with high sulfur content. The high indebtedness of the company means that it would be particularly vulnerable to reduced access to capital markets for fossil fuel companies.

<u>Approach to climate change</u>

- Although the narrative reporting of the 20-F highlights Climate Change as a Risk Factor, this is not reflected in the company's strategy and CAPEX plans. The 2021-25 Business Plan has no particular focus on climate concerns with the word "sustainability" being used to refer to the company's goal of increasing crude oil reserves.
- Pemex acknowledges that international concern over emissions and the potential for new laws and regulations could adversely affect the company's financial condition with possible carbon taxes, efficiency standards, cap-and-trade and emission allowances all mentioned. More specifically, the narrative reporting highlights that Mexico ratified the Paris Agreement in 2016 and committed to a 22% reduction in greenhouse gas emissions and 51% reduction in black carbon emissions by 2030 against a 2013 baseline. Subsequently, Mexico amended the General Law on Climate Change to include various Paris-related commitments, requiring a 14% fall in emissions from the oil and gas sector, with these emissions being measurable, reportable and verifiable, and the creation of a national emissions trading system. However, the implications for Pemex of Mexico's adherence to the Paris Agreement, including these legal amendments, are not articulated or explored.
- Pemex does, however, list a number of initiatives that it considers should mitigate climate change including: improvements to the company's gas infrastructure, including refurbishment of failing compressors in processing complexes; a methane emission / leakage reduction programme; participation in the Pilot Program for the Emissions Trading System; and an update of the vulnerability map for the effects of climate change.

Accounting: judgements and consistency with other reporting

Accounting judgements		Significant concerns

- Pemex reports under IFRS as issued by the IASB.
- There is no reference in the notes to the financial statements that accounting judgements have been impacted by climate-related considerations. While there are single price assumptions for oil and gas disclosed in the financials, there is no accompanying explanation and no suggestion that these numbers have been impacted in any way by climate considerations.
- Although there were net impairments of Ps.36 billion in 2020, this does not appear to be linked in any way to longer-term concerns over the energy transition. In fact, this net figure masks a significant reversal of impairments in the exploration as oil prices recovered, which was more than off-set by impairments in the refining assets due to lower production. The

estimated useful lives for plants and pipelines stretch out to up to 35 and 45 years respectively.

Consistency with other reporting		Significant concerns

- The financial statements appear to be silent on climate considerations, which is inconsistent with the narrative reporting of the 20-F that highlights climate risks.
- Pemex has not yet published a Sustainability Report for 2020, although it did publish a Sustainability Report last year in Spanish only. This report had more extensive discussion of climate issues and greater detail of carbon emissions data. However, the emissions targets relate to reductions in carbon intensity rather than absolute carbon emissions levels.

Climate assumptions in accounts: visibility and Paris alignment

Visibility of climate assumptions in accounts		Some concerns

- Pemex appears to have some very limited disclosure of climate-related assumptions in the financials, which refer to a single "average crude oil price" for 2020 of $52.96 and a single "average gas price" of $5.21. It is not clear what these prices mean, for example, whether they are some kind of weighted average price forecast. There is no suggestion that there are any climate considerations behind these oil and gas prices or, indeed, any explanation of any kind.

Paris alignment		Significant concerns

- There is no suggestion by the company that the single oil and gas prices disclosed in the financials are aligned with the Paris Agreement in any way.
- Although the Risk Factors in the narrative reporting explain that Mexico is a signatory of the Paris Agreement and has committed to specific emissions reductions, the implications of this for Pemex are not carried over to the accounts.

Audit: visibility in CAMs and consistency check

Audit firm: KPMG Cardenas Dosal	Responsible partner: Ericka Rangel Cuevas[1]
Audit standards: PCAOB	

Visibility in Critical Audit Matters		Significant concerns

- There is no reference to climate change in the auditor's report.
- There are two CAMs identified:
  i. Assessment of the impact of estimated oil and gas reserves on amortization expense related to proved oil and gas properties.
  ii. Impairment of exploration and production and industrial transformation cash generating units.
- These CAMs were identified because they are subject to significant judgements and estimates by management, some of which could be impacted by climate risk, such as forecasted production and future commodity prices, but there is no indication that climate issues have been considered.
- The audit report highlights the notes to the financials that "raise substantial doubt about its ability to continue as a going concern", but do not appear to take a view on this question, simply stating that the consolidated financials have been prepared assuming Pemex will continue as a going concern.

[1] Audit partner for 2020 20-F Annual Report is not stated, but Ericka Rangel Cuevas was the KPMG Cardenas Dosal Engagement Partner for the previous audit cycle concluding in 2020.

Consistency check		Significant concerns

- PCAOB audit standards require the auditor to read other information that is presented together with financial statements and the auditor's report thereon. The auditor's report is silent on the outcome of the review, which implies that no material inconsistency was identified in the other information within the 20-F. However, the absence of climate considerations in the audited financial statements does appear inconsistent with the climate-related risks identified in the narrative reporting of the 20-F annual report.

The Climate Accounting Project is an independent investor-led project to reinforce the statements of the IASB and IAASB that material climate change issues are incorporated within their standards. This analysis seeks to understand the extent to which companies and auditors are delivering against this aspect of these standards and similar local standards.		**Key**
		Good practice
		Few concerns
		Some concerns
		Significant concerns

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