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Changes, Risks for Financing Energy Projects in Mexico

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The historic energy reform in Mexico approved in December 2013 is a constitutional reform that fully opens generation and supply within the Mexican electricity and oil and gas sectors. In 2014, most of the implementing legislation and corresponding regulations were issued. During 2015 the new legal framework should be completed, including the corresponding technical standards, model contracts, permit guidelines, administrative guidelines and other detailed rules.

There is no question that this landmark reform will provide significant benefits to the Mexican economy by bringing, among other things, key investments, jobs, new technology, better infrastructure and world-class industry practices. Nevertheless, the overhaul of the Mexican legal framework has established a completely different regulatory environment. Some of these changes have already impacted non-recourse project finance in Mexico. Mexican and foreign banks were very comfortable with the credit rating and risk of the traditional major government off-takers such as Comisión Federal de Electricidad and Petróleos Mexicanos.

These government agencies typically would sign long-term agreements, and local and international lenders were willing to extend financing based on the cash flows resulting from those agreements based on the high credit ratings. However, these entities will cease to be government agencies with an implicit credit support from the Mexican government. Under the reform they will become state productive companies. It is expected that under this new form, from a legal perspective, they will become similar to private corporations, and will therefore be assessed by lenders as an individual credit risk.

Formerly, in the electricity sector, sponsors, lenders, and developers were comfortable with the self-supply scheme which was allowed under the 1992 Electricity Law and which helped develop more than 20,000 MW of new generation.

Now, with the recent energy reform there will be a wholesale electricity market for which rules need to be fully analyzed and understood before banks and other institutional investors decide to move forward with financing alternative energy projects. A functioning market with a track record of reliable price determination will be needed before market participants accept that market as a benchmark.

Key Risks

In order to finance a project in Mexico, especially with non-recourse project finance, there must be a detailed risk analysis of the project including general and non-technical risks. (Non-recourse project finance or senior limited debt is probably the largest source of capital for renewable energy projects. It is money lent by the banks to the project that is repaid to the bank exclusively from the assets of the project. If there is a default by the special purpose vehicle or SPV, these senior debt providers will have a priority right to collect before any unsecured senior lenders or equity providers.)

Risk allocation and mitigation based on detailed due diligence is essential. The general risks of an infrastructure energy project usually entail the following: 1. construction and technology risk, 2. operational risk, 3. market risk, 4. political risk, 5. counterparty risk and 6. legal and regulatory risks.

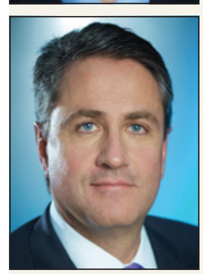
The following risks are currently stalling financing of alternative energy projects in Mexico whether greenfield or brownfield:

• *Low electricity prices*: Developers are dealing with significant CFE electricity rate reductions which result from lower fuel prices, but these might increase after the mid-term elections. It is difficult for an alternative energy project to offer these low prices in a long-term contract and still earn an acceptable rate of return.

• *Wholesale market*: The new wholesale market is bringing uncertainties in project finance because banks were very comfortable dealing with a long-term power purchase agreement where the off-taker was CFE or a large rated company. The rules for this new wholesale market are new to everyone and they have not been tested. Today, finding an off-taker who wants to execute a PPA for more than five years is not an easy task. Off-takers want to take their time to study all their new alternatives such as generating power, importing, doing a request for proposal, buying as a qualified user from the new market at spot prices, bilateral contracts or buying from a marketing company or from a supplier.

• *Non-technical risks*: Developers are concerned with security issues, lack of infrastructure, compliance and anticorruption, rule of law, land issues (i.e., rights of way), health and worker safety, lack of infrastructure, social issues with local communities, etc.

Project non-recourse finance will remain one of the key ways to finance energy projects in Mexico, although companies with solid financial statements and positive historic performance may look for other alternatives, like the capital markets. Over time, new alternatives will develop but we anticipate that the traditional off-takers like CFE and Pemex will still play an important role, due to the solid market perception they hold to date.



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