

# Mexican Energy Sector Restructuring: New Opportunities for Renewables

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The ongoing effort to restructure the power sector in Mexico, together with Mexico's strong policy on combating climate change, have created compelling opportunities for investors in renewable energy projects that likely will persist this year. As Mexico continues to transition its electricity sector from a vertically integrated, state-owned and -controlled structure to an unbundled one with private and public ownership, investors will be required to bear more market and investment risks than before. However, these risks are familiar to investors in other mature electricity markets and do not represent insurmountable obstacles to capitalizing on new Mexican renewable energy opportunities.

## Electricity Sector Restructuring

The "Secretaría de Energía," or Energy Ministry (SENER), is overseeing the restructuring of the electricity sector pursuant to the August 2014 "Ley de la Industria Eléctrica" (Electric Industry Law) and related legislation (Reform Legislation). The intention of the reform is to lower prices by shifting to a more competitive market and promoting renewable energy generation.

Prior to the Reform Legislation, the "Comisión Federal de Electricidad," or Federal Electricity Commission (CFE), was the state-owned enterprise responsible for operating the electricity sector. CFE controlled power purchasing, planning and transmission and was the primary generator that owned most of the total installed capacity and electricity production in the country. Opportunities existed for private entities to participate in generation but were mostly limited.

Under the new regime and for the near term, CFE continues as the primary retail supplier of electricity, but it has become a holding company with separate generation, transmission, distribution, supply and marketing subsidiaries that operate semi-independently. As a result, parties doing business with CFE must look to the specific credit profile and assets of the CFE entity with which they are contracting, and such parties can no longer rely on the asset and credit profile of the consolidated/integrated energy company. In addition, system operations have been transferred to the "Centro Nacional de Control de Energía," or National Energy Control Center (CENACE). This independent system operator (ISO) for the new wholesale power market plays a similar role to that performed by ISOs in the U.S., with responsibility for ensuring access to the grid, operating the system in a reliable manner and assuring availability of sufficient supplies to meet customer demand. This year, CENACE will introduce new market components, including the real-time wholesale market, the balancing capacity market and financial transmission rights. With these changes, the electricity sector will transition to a structure akin to markets such as the California ISO, which will be very familiar to independent power producers and financiers in the U.S. electricity market.

## Power Contract Auctions

The Mexican government made an aggressive commitment to renewable energy with the 2012 General Law on Climate Change, requiring 35 percent of electricity production to come from renewable sources by 2024. A key component of that commitment is power supply solicitations in which CENACE auctions long-term (15-year) power contracts with CFE to renewable energy generators.

Two auctions have been held to date. At the first, 11 winning bids were selected for wind and solar projects totaling 1,720 megawatts (MW) of generating capacity with an

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average bid price of US\$41.80 per megawatt-hour (MWh). The winning bids in the second auction represented 2,871 MW with an average bid price of US\$33.47 per MWh. Each auction received bids from approximately 60 to 70 local and international prospective suppliers. A third auction is planned for April 2017.

The CENACE auctions are governed by the “Bases de Licitación de la Subasta de Largo Plazo,” or Bid Rules for Long-Term Auction, which are published before each auction. Pursuant to these rules, bidders must provide a detailed construction schedule with specific milestones, including a fixed commercial operation date, certify their technical expertise and identify their contractor, among other details. The rules include a form of non-negotiable power purchase agreement (PPA) that winning bidders must execute with CFE. The new PPA contains terms that generally have been included in project financings in the U.S. and elsewhere but not some of the protections that benefited generators in previous power purchase agreements with CFE in Mexico.

## New Terms of Agreement

The new PPA between a CFE subsidiary and the generator has a 15-year term that runs from the fixed commercial operation date. However, the uncertainty around pricing in the new wholesale electricity market is hampering developers’ efforts to secure long-term financing extending into the period following expiration of the 15-year PPA. Under the PPA, the CFE counterparty makes payments in accordance with the actual amount of energy delivered each month and performs year-end reconciliations that aggregate the monthly amounts delivered to determine compliance with contracted quantities. Because ownership was a material consideration in securing the bid, there are some limitations on changes to generator ownership. However, CFE’s restructuring and the new regime present credit, curtailment, construction and operational risks that were mitigated under the old regime.

## CFE Credit Risk

Under the old regime, CFE’s obligations were guaranteed by the government. Given this guarantee and CFE’s formidable balance sheet, it enjoyed a favorable international credit rating that made the former PPA with CFE an attractive and bankable contract for investors and lenders alike. Under the new regime, while the government continues to own the CFE counterparty, it no longer guarantees the subsidiary’s obligations. In addition, the CFE counterparty’s balance sheet reflects the fact that it owns only a subset of the assets that its predecessor entity held, and it must be responsible for its respective share of long-term liabilities and obligations.

Anticipating concerns about credit, the Reform Legislation requires the CFE counterparty to post a guarantee equivalent to one year of its contractual obligations. It is unclear whether the

government would ultimately backstop CFE through an implied guarantee if the market assigns a high-risk premium to project financings under the new arrangements. Also, in the event that a CFE counterparty default causes generator termination, the CFE counterparty must fund the full amount of the contract into a trust in order to cover the difference between spot market and contract prices. However, the CFE counterparty’s contractual obligation does not eliminate the risk that the CFE counterparty may fail to comply with this funding obligation, either because it lacks the necessary financial resources or for other reasons.

The Reform Legislation contemplates further restructuring CFE, which could result in a CFE counterparty no longer being a subsidiary or affiliate of CFE. In that scenario, the CFE counterparty would be required to increase its posted guarantee, but the generator would still take the risk that the CFE counterparty might not post the requisite guarantee.

## Curtailment Risk

Generators also are subject to certain curtailment risks under the new PPA. To be accepted and remain active in the market, generators must acquire and maintain their status as a market participant, which includes executing a market participant agreement with CENACE. Both this agreement and the new PPA require that the generator abide by CENACE’s operational instructions. While the regulations governing CENACE indicate that dispatch decisions will be based on impartial criteria, the process for determining dispatch and curtailment priorities is not plainly defined, and it is unclear what factors might affect these decisions beyond reliability.

Under the new PPA, generators that are instructed not to deliver energy by CENACE are not compensated, and generators are allowed to terminate the agreement only after six months of curtailment. This change is a significant departure from the former PPA with CFE, where CFE generally was required to pay in the event of curtailment.

## Construction and Operational Risks

Similar to the curtailment risk, projects developed under the new PPA will be subject to other construction and operational risks. For construction, generators are responsible for strictly meeting the schedule set forth in the auction bid rules and annexed to the PPA. While certain extraordinary events, such as civil disturbance or the occurrence of a *force majeure*, allow for a schedule delay, project holdups due to other factors will result in the developer incurring penalties per milestone missed. Furthermore, the CFE counterparty can terminate the PPA if commercial operation is not reached within 12 months of the fixed commercial operation date.

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In addition, the PPA does not provide compensation in the event of project delays or other missed milestones resulting from government actions or inactions. For delays brought on by issues such as permitting or an inability to interconnect on time because of grid construction, the fixed commercial operation date may be delayed with no penalty to the generator; however, the generator is not compensated for the delay. The generator has the right to terminate the agreement after six months of delays due to government actions that affect the project schedule.

## **Conclusion**

The restructuring of the electricity sector and Mexico's commitment to renewable energy present investors with attractive, long-term opportunities in renewable energy projects. However, changes to the market structure and regime remove important investment protections afforded to project owners under the previous regime. Investors will need to undertake careful diligence of curtailment and other risks that might not have been a focus previously.