MEXICO: LATIN AMERICA'S RENEWABLE ENERGY CROWN JEWEL

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In contrast to unpredictable renewable energy policies in the United States and the European Union, Mexico has emerged as a lightning rod for renewable energy investment. As renewable energy investors assess changing global opportunities, Mexico continues to offer numerous stable investment prospects. Mexico's investment-grade credit rating provides potential investors one of the few high-grade investment environments in Latin America. Additionally, the sharp reduction in contracted large-scale renewable energy opportunities in the U.S. and Europe has catalyzed recent interest in Mexico.

THE OPPORTUNITY

The Mexican economy has been bolstered by strong international demand for its commodities and a competitive labor force favored by numerous U.S. industries following a reevaluation of a low-cost production chain previously outsourced to China. As a result, continued economic growth has reenergized interest from foreign investors into Mexico's power generation and transmission systems. Because the long-term relative stability of Mexico's economy provides investors with safe, profitable power sector development opportunities, savvy political technocrats in the country are using the investment window to attract additional foreign investors and are taking advantage of downturns in other international renewable energy markets to thrust the Mexican renewable energy sector to the forefront of the global market.

Given President Enrique Peña Nieto's favorable energy policies and a push by the federal government to further modernize the country's power sector, Mexico's renewable energy sector will continue to provide opportunities for private equity investors, development companies, construction companies, and lending institutions. However, one of the challenges for investors is to understand the inherent risks of investing and operating in Mexico.

During the 1980s and 1990s, Mexico was a darling of the investment community looking to capitalize on attractive returns and diverse opportunities across infrastructure sectors. Many region-specific private equity funds emerged during this period. Infrastructure development companies formed dedicated Latin American teams. But as competition for infrastructure development grew and profit margins declined, investors and developers soon turned to other markets – such as Eastern Europe, Russia, the Middle East, and Asia – that were experiencing their own infrastructure development booms and offering more profitable investment opportunities. Investors and developers also began looking to the U.S. and Europe, which were also experiencing economic prosperity and aggressive energy sector build-outs. With this shift in regional focus, many private equity players and developers deemphasized their capital deployment efforts in Latin America and disbanded their "LatAm" teams.

The demise of these region-focused teams meant a loss of institutional knowledge for these firms and an opportunity for smaller regional developers to gain a foothold in Mexico. As new energy investors now move into uncharted waters, they would do well to study the lessons learned from past investors in the Mexican power sector during the last 20 years. Edmund Burke's statement that "those who don't know history are destined to repeat it" holds true for

the new generation of investors looking to make their fortunes in the bonanza that is the newly reinvigorated Mexican energy sector. Successful investors must retain external advisers with a deep knowledge of the Mexican energy market in order to properly judge market opportunities and investment risks.

THE MEXICAN ELECTRICITY SECTOR

In the early 1990s, the Mexican government embarked on a massive infrastructure build-out program in its electricity sector. Mexico developed a well-defined legal framework to permit private investors to participate in the development and ownership of power generation facilities to supply the national electric utility, *Comisión Federal de Electricidad* (CFE), as well as large industrial and corporate customers. The CFE independent power project (IPP) program has become an extremely effective international power plant development program; the speed of power plant deployment and the low costs associated with the long-term energy pricing of the power plants demonstrate the competitive and transparent bidding environment CFE has been able to foster. CFE's IPP program allowed the government to refocus its own capital investments into the national transmission grid.

To promote renewable energy development and diversify the country's power generation portfolio, CFE adopted attractive policies regarding wheeling to benefit renewable energy projects. CFE's preexisting wheeling structure failed to account for renewable energy's intermittent nature and penalized projects for failing to produce a stable constant electricity supply. In order to account for wind and solar power's intermittent nature, CFE created a system where a renewable energy project can bank excess energy production during periods when an off-taker does not require energy from the project and allow the user to access the banked energy during periods when the power project does not produce sufficient energy to meet its needs. Additionally, the government also enacted postage-stamp wheeling charges earmarked solely for renewable energy to benefit renewable energy production. As a result, buyers of renewable energy see power rates that directly compete with fossil fuel-generated energy.

The Mexican government provided for a sea change in renewable energy development in 2014 by enacting sweeping reforms to the entire electricity sector. Renewable energy projects that had begun their interconnection process with CFE before the government passed the reforms have been grandfathered into the renewable energy policies in place prior to the enactment of the reforms. One drastic change enacted by the government is that renewable energy offtakers are no longer required to be shareholders of the project company developing the renewable energy project. By lifting the "self-supply" requirement, offtakers can be solely short or long-term customers of renewable energy projects. The new electricity reforms define "available customers," with whom energy producers can contract, because they have an aggregate load demand of at least 3 MW. After one year, the threshold will be reduced to 2 MW, and after two years it will be further lowered to 1 MW of aggregate load demand.

The new market structure portends to allow greater flexibility in aggregating customers with varied energy demands and contracting strategies. In some cases, developers may look to secure long-term anchor customers with attractive pricing with the majority of the available capacity of a project, which supports long-term nonrecourse financing. Once a developer secures its core customers, the developer then can contract out the remaining available capacity with shorter-term and higher-priced off-takers to increase project profitability.

The wildcard in renewable energy development for Mexico is whether the government policymakers suspend postage-stamp wheeling and energy banking for new renewable energy project developments. Removing postage-stamp wheeling may slow down future wind and solar developments by forcing developers to site their projects closer to off-takers, thus losing the ability to aggregate loads on a nation-wide basis and failing to optimally use

Mexico's renewable energy sources. Any dismantling of the energy banking system can also delay renewable energy development by forcing developers to install expensive storage alternatives to compensate for the intermittent nature of solar and wind power generation or purchase replacement energy from the proposed wholesale energy market, which the government has yet to develop. The reforms also provide for a system of clean energy credits, which the government must still develop, regulate, and implement.

READILY AVAILABLE FINANCING

The true test of whether the projects in a market are viable is determining if third-party, non-recourse financing is available. In Mexico, Japanese, U.S., and European commercial lending institutions are actively looking for lending opportunities to well-structured renewable energy projects. Multilateral lending institutions, such as the International Finance Corporation, the Inter-American Development Bank, and North American Development Bank are also working in the Mexican market with creative financing structures. In addition to multilateral financing institutions and commercial lenders, international development banks have supported infrastructure projects that promote certain economic, environmental or social objectives. Some international development banks have even prioritized the Mexican market as a target lending environment to spur specific project development, such as renewable energy power plants. Understanding the present requirements of potential lenders and the structures of past financings is essential for developers trying to secure nonrecourse project financing. The most successful projects will be those that incorporate this knowledge early on in the development phase of a project. Failure to anticipate these requirements creates an Achilles heel for uninformed market participants.

CONCLUSION

The Mexican energy market is poised to attract the majority of new renewable energy investment in the Americas if Mexican policymakers continue to view renewable energy as a critical part of the country's overall power generation portfolio and enact policies to promote increased wind, solar, and geothermal development. Mexico's natural renewable resources and its thriving economy have provided it with an opportunity to become a world leader in renewable energy development at a time when developers the world over are searching for investment opportunities.

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