

Slowing the juggernaut

As Mexico seeks to introduce greater private sector involvement into its electricity market, Akin Gump Strauss Hauer & Feld LLP partner **Dino Barajas** argues that the country is unintentionally slowing an otherwise healthy power industry



In 1992, Mexico thrust itself on to the forefront of the international power private investment stage by amending its power sector laws to permit private sector investment in power generation assets. Those early energy reforms permitted developers and investors to enter the power generation sector (which had been reserved exclusively for the Mexican government) and sell power to the Comisión Federal de Electricidad (CFE), Mexico's national electric utility, pursuant to power purchase agreements, and provide power to private sector participants under energy self-supply contracts. The opening of the energy market brought droves of international developers from throughout the Americas, Europe and Asia who were eager to enter one of the largest and most robust power markets the world. Over a very short period, the Mexican power sector was able to convert itself into one of the most modern and efficient in the world through the installation of new large-scale gas-fired and hydroelectric power plants using the latest technologies available in the international power market.

Following the initial transformation of the Mexican power sector through constant private sector new build proposals, supported by long-term CFE offtake power purchase agreements, the Mexican government embarked on additional innovative policies to promote the inclusion of additional renewable energy technologies into the country's generation portfolio. The government created a multi-tiered energy banking credit system to permit renewable energy power projects to "bank" their excess energy production with CFE during periods when self-supply energy partners could not utilise energy produced by their projects. The government also instituted an allowance for "postage stamp" wheeling charges to apply to renewable energy projects so that a power plant could be located within the most productive renewable energy resource zone and its energy output could be credited as delivered to energy offtakers located anywhere within the country (with the exception of Baja California for projects located outside of Baja Norte and Baja Sur). These power sector innovations permitted generators to aggregate the power loads of multiple energy offtakers located throughout

the country and provide for economies of scale within a single power plant site. Additionally, these policies took into account the intermittent nature of renewable energy technologies such as wind and solar by allowing the offtaker to utilise "banked" energy during low or non-production periods.

Global events have also catapulted Mexico into the power development pole position within the Americas. The scarcity of available long-term power purchase agreements with creditworthy offtakers in the United States and Canada has forced US and Canadian developers to redirect their local jurisdictions development efforts and look to Latin America as a way to jump-start their development pipelines. Other jurisdictions within Latin America, though attractive due to high energy prices, do not have as deep an available pool of contractable megawatts (MWs) whether from local utilities or private energy offtakers. Additionally, changes in renewable energy policies in certain European energy markets, including Germany and Spain, have forced European renewable energy developers and equipment manufacturers to look to Mexico as one of the most promising markets for new large-scale wind and solar projects. Following the imposition by the US of trade tariffs on certain Chinese solar components, Chinese solar equipment manufacturers have also redirected their marketing efforts to Mexico in the hope of gaining strong new market share.

With this perfect global storm, Mexico's power sector has become the lightning rod for international power development and investment. Developers, power equity funds and lenders have renewed their in-country marketing efforts and prioritised Mexico as a primary target market for the next few years. In an attempt to further capitalise on Mexico's prominence as a global investment magnet, President Enrique Peña Nieto took the opportunity to enact historic sweeping energy reforms last December. These reforms were primarily focused on revolutionising the oil and gas sector by permitting direct private sector investment in the exploration and exploitation of hydrocarbons for the first time in nearly 80 years following the ousting from Mexico of foreign oil and gas companies and the nationalisation of all hydrocarbon resources by President Lázaro

Cárdenas in 1938. Given the sweeping reforms already transforming the hydrocarbon sector, the government also attempted to further push the envelope and introduce additional policies designed to make the electricity sector into an open market-based sector with dynamic competitive pricing.

The 2014 energy reforms are designed to shatter CFE's control over the electricity sector by introducing increased competition through greater private sector involvement. One of the most radical developments has been the announcement that the government intends to create a wholesale energy market where large-scale commercial and industrial energy consumers can purchase electricity to meet their energy demand. Private sector generators, through merchant power plants, will be permitted to participate in the wholesale energy market on a competitive basis alongside CFE. Unfortunately, these attempts to ride the reform momentum wave and further diversify the Mexican electricity market may have unattended negative consequences on the very market they are trying to grow.

Given that history can be strong predictor of the future, one needs to survey similar attempts to institute wholesale energy markets with merchant power plants in other jurisdictions to gauge the potential success of the Mexican government's current efforts. Failed attempts to promote wholesale energy markets through the introduction of merchant power plants can be found in robust energy markets such as California and Texas during the late 1990s and early 2000s. Despite having private sector participants already dominating these markets (and the absence of a strong governmental generation player), early efforts to design competitive wholesale power markets proved difficult because merchant power plants were unable to weather sustained pricing downturns in the market over an extended period of time. Many of the participants in these markets were merchant power plants which had been project financed by commercial lenders eager to provide funding at extremely leveraged levels. As numerous power projects defaulted on their financing obligations, the commercial project finance sector went into a death spiral tailspin and its eventual recovery resulted in a much more conservative and "merchant power plant adverse" lending environment.

Mexican policymakers' expectation that private sector participants can provide any meaningful energy load into a wholesale market may be misplaced because the development of large scale merchant power plants will be hindered by the unavailability of non-recourse project financing. Additionally, power generation developers will be wary of constructing power plants utilising their

balance sheet capital, given that the wholesale energy market at its inception will still be largely dominated by a government-controlled CFE.

Despite market design challenges which may lead market observers to conclude that a wholesale energy market is years away at best, many large potential Mexican energy offtakers have become hesitant to proceed with the execution of power purchase agreements in the near term as they "wait and see" how the market deepens. The creation of this unintentional uncertainty may cause Mexico to fail to fully capture the ground swell of interest from developers and investors currently investigating market opportunities in the Mexican electricity sector. The government would have been best served by focusing its efforts on the reopening of the oil and gas sector first and then turning its attention to the further liberalisation of the power sector after the successful implementation of the 2014 oil and gas reforms.

Aside from the complications surrounding the creation of a wholesale energy market, the renewable energy development community has also become concerned over whether the Mexican government will move away from the innovative policies it had already enacted to promote renewable energy development within the country's generation portfolio and instead opt for an unrestricted hyper-competitive market where all technologies are forced to compete for consumers strictly on price and without any consideration for each technology's unique attributes. The government has announced a green energy credit system as a method to allow renewable energy projects to compete with fossil fuel-based technologies. Unfortunately, these potential policy changes have also clouded what was already a fully functioning and attractive renewable energy development environment, which had been incredibly active during the past five years for wind developers and the past 18 months for solar developers eagerly seeking self-supply energy partners.

The next 12 months will provide greater clarity as to whether the country's energy policymakers have taken the right steps with respect to their newly announced market objectives or whether they should have left the current structures in place and reaped the benefits of having external market forces make an existing attractive energy sector even more attractive in comparison with other regional markets. The successful market players will be defined as those that have the benefit of existing market knowledge based on the past 20 years of Mexican power project development experience and the foresight to study the lessons learned by their predecessors.

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