FIRST POWER AUCTION UNDER MEXICO'S NEW POWER REGIME: CAUTIOUS OPTIMISM FOR INTERNATIONAL INVESTORS

Results of Mexico's First Power Auction

Mexico has just announced the winners of its first-ever power tender.[1] Whilst much attention has been given to Mexico's reform of its oil and gas industry, the electricity sector is also undergoing significant change. In November 2015 the state market operator, *Centro Nacional de Control de Energía* ("CENACE") announced the first auction of long-term power purchase agreements for the sale and purchase of power, capacity and clean energy certificates (*Certificados de Energía Limpia*, "CELs"). Unlike other jurisdictions across the region, the auction was not only for renewables (biomass, geothermal, wind, solar, tidal, nuclear, etc) but also gas fired power projects and efficient co-generation. In the first round, the winning offers were limited to electricity generated by solar (56%) and wind (44%), reportedly for a total estimated amount of 5.3 million GWh. The list of eleven winning bidders out of more than 60 pre-qualified bidding entities indicates strong interest amongst well-known international developers.[2] As we look ahead, there are several questions about the opportunities and challenges that Mexico's power market liberalization will present for those seeking to provide funding on a project financing basis, not just in this first round of bids but also beyond.

New model of power purchase agreement (PPA)

The new form of PPA issued by CENACE in connection with the auction marks a significant departure in some respects from the form of PPAs entered into by independent power producers with the state-owned, vertically integrated utility company, the Federal Electricity Commission (*Comisión Federal de Electricidad*, "CFE"), which has dominated the wholesale generation market under the previous power production scheme (*Los Proyectos de Inversión de Infraestructura Productiva con Registro Diferido en el Gasto Público*, "PIDIREGAS").

Under the old form of PPA, CFE would pay for power capacity in US Dollars as the sole offtaker, assume most of the change in law and force majeure risk and provide a termination payment in the event of generator default or prolonged force majeure that purported to enable lenders to recover most if not all of their debt financing. Several of these bankable risk allocation mechanisms have been removed or modified in the new PPA, which no longer contemplates the transfer of power assets to CFE.

Offtaker Credit Risk

On 29 March 2016, Mexico published rules governing the unbundling of CFE through the setting up of nine new subsidiaries, comprising six power generation companies, a transmission company, a distribution company as well as the "Basic Energy Supplier" (*Suministrador de Servicios Básicos*), which is expected to be the counterparty buyer under the new PPA. Although CFE could still be party to the PPA on a joint and several basis with the Basic Energy Supplier, this may only be for the first round of auctions. The financial stability of this CFE subsidiary remains to be seen, in particular whether it will benefit from the subsidy support of the Federal Government as currently provided to CFE. In future, any company registered under Mexico's new market rules will be able to enter into PPAs as a buyer through a market clearing system. These developments will raise questions about counterparty risk and in particular necessitate greater scrutiny of the credit standing of offtakers and the financial support instruments that may be offered by such entities in future projects.

Merchant Risk

Whilst payments are to be made in Mexican Pesos, generators may opt for monthly power payments to be indexed to US Dollars and for inflation, thereby helping to mitigate currency risk and opening the door to US Dollar financings.

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[1] The winning bidders are reported to be SunPower Systems, Enel, Energía Renovable de la Península, Recurrent Energy Mexico Development, Aldesa Energías Renovables, Vega Solar, Jinkosolar, Photoemeris Sustentable, Energía Renovable del Itsmo, Sol de Insurgentes and Consorcio Energía Limpia 2010. They will develop new wind and solar plants to be located in Guanajuato, Coahuila, Yucatán, Aguascalientes, Jalisco, Tamaulipas and Baja California Sur. The list can be found at: http://www.cenace.gob.mx/Docs/MercadoOperacion/Subastas/31%20Comunicado%20Subasta%20v2016%2003%2030.pdf"

[2] The list of pre-qualified bidders can be found at: http://www.cenace.gob.mx/Docs/MercadoOperacion/Subastas/28%20Resultados%20de%20Etapa%20de%20Precalificacion%20v2016%2003%2022.pdf

However it remains to be seen how developers will seek to raise long-term debt tenors for power assets with a 20-25 year life given the merchant risk element of the new PPA, whose take-or-pay structure guarantees only 15-year contracted revenues for capacity and energy sales and 20-year contracted pricing for CELs.

The valuation of excess capacity or power sales will likely remain a challenge for some time as a functioning spot market has yet to evolve and any benchmarking will need to account for ongoing regulatory changes that may affect market pricing in the long-term. Although CELs may be accumulated over time and can provide some revenue cushion, financiers will be looking closely at structuring solutions to manage the merchant risk exposure during the final few years of the debt tail. The negative pricing mechanism may provide some protection for generators, however the absence of contracted cash flow after year fifteen may mean that lenders will expect robust coverage for ongoing operating and maintenance expenditures and debt service obligations.

Termination Payment

No termination payments are envisaged for generator defaults nor prolonged force majeure. Whilst a default by the buyer triggers a right to termination payment calculated on the estimated current value of the annual payments that would have been earned over the remaining term of the PPA, this is no longer to be made as a lump sum amount. Post-termination the buyer is required to establish a termination trust into which 1 year's worth of annual purchases are to be deposited within 10 business days of termination, with the buyer having the option to either deposit the remainder into the trust within 6 months or procure the issuance of a standby letter of credit acceptable to the generator to cover such amount. Alternatively, if the buyer does not deposit the remainder into the trust, it can opt to fund the trust on a monthly basis so as to ensure it has funds equivalent to 1/6th of the annual payments at all times. In turn, the trust is to pay the generator monthly instalments that are sized to cover the difference between the spot market price and the contracted price (with any excess to be eventually returned to the buyer).

Not only is this trust structure novel, its workability and enforceability remains untested. On the one hand, the termination regime offers flexibility to lenders as it leaves them with an operating asset that can generate revenue in an open wholesale electricity market. On the other hand, the lenders have less certainty of an immediate exit. The generator will in effect be exposed to spot market risk and reliant on the buyer's credit standing to ensure the trust has sufficient funds to meet any shortfall between the contracted PPA price and spot market prices.

Force Majeure and Political Risk

The PPA also leaves several areas unaddressed which are of particular relevance in light on ongoing energy reforms, notably in respect of interconnection, transmission and despatching priority. Protections under the old regime for force majeure, in particular ongoing capacity payments from CFE, which would cover debt service obligations and thereby effectively shield lenders from such risk, no longer seem to be available. There is also no termination payment following the occurrence of a prolonged political force majeure event, such as revocation of permits or non-availability of grid access.

Since transmission and distribution facilities will remain under state ownership, with private sector involvement limited to construction and ownership of such facilities, a key issue will be how CENACE ensures an open and non-discriminatory access regime. The form of interconnection agreements to be entered into by generators as well as guidelines issued by the Energy Regulatory Commission (*Comisión Reguladora de Energía*, "CRE") set forth the circumstances in which transmission and distribution facilities could be suspended. Whilst the PPA provides some mitigation for interconnection delays or suspension through the force majeure and extraordinary event provisions, it is less clear on its treatment of curtailment issues. It remains to be seen how CENACE will determine constraints or losses in the grid system and whether it will give priority to plants with the lowest operating costs as officially intimated, or whether it will allocate priority on the significance of the project size and contracted capacity under the PPA so as not to inadvertently penalize those generators making larger investments. Secondary regulations may tackle such risks, which are largely outside of the generator's control, yet these remain at a formative stage.

Other Issues

In some areas the PPA retains provisions that raise issues which sponsors and financiers will be familiar with under the former PPA, such as construction milestones, time limitations on step-in rights, conditions to enforcement of share security, and controls on the replacement of construction contractors and operators. However, the PPA also places additional burdens on generators, especially during the construction phase. If the achievement of commercial operations is delayed due to a generator default, the generator will not only be required to increase the performance bond and pay liquidated damages, but will also be required to meet contracted supply obligations under the PPA through spot market purchases. There is also the potential risk of termination for material breach. This area will likely necessitate greater scrutiny of risk allocation mechanisms and mitigants under the contracting structure, in particular sponsor support, the pass-through of delay risks to contractors and liquidity facilities.

Cautious Optimism for the Future

Notwithstanding these open issues, market reactions suggest that the PPA may be broadly bankable. The risks identified will need to be examined in light of ongoing regulatory, institutional and legislative changes that are shaping the contours of Mexico's new power market. Many of these changes will continue to evolve after the first round of projects are developed. The recently published list of winning bidders suggests that international participants in the initial round of projects are confined to established market players or independent power producers willing to assume such risks or draw on corporate balance sheets or tap into domestic bank financing. As such, bankability concerns may not be comprehensively tackled in this first round of developments. Nevertheless, international commercial banks and development finance institutions have appeared receptive to new sponsors, and will likely emerge as a significant source of financing as the independent power sector develops in Mexico. Moreover, despite the evolving nature of the new PPA and Mexico's electricity regime, there are several structuring solutions available to give reason for cautious optimism amongst international investors seeking to enter Mexico's power market.

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J201801030052020