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Mexico Energy Initiative Negative for Private Power Producers

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Fitch Ratings-New York/Monterrey-08 November 2021: The energy initiative proposed by Mexico's President Lopez Obrador to amend the constitution would result in negative rating actions to private power projects were it to become law, Fitch Ratings says. Energy reforms passed in 1992 and 2013 would be reversed and full control of the electricity market would be given to the Federal Electricity Commission (Comision Federal de Electricidad [CFE], BBB-/Stable).

Morena, Mexico's ruling party, has pushed out debate on the initiative into 2022. To become law, the initiative must be ratified by two-thirds of the lower and upper houses of Congress, and Morena will need to secure opposition party votes to meet this threshold, making the measure's passage unlikely. But should it pass, credit implications would be significant.

The proposal would cancel all private power purchase agreements (PPAs). PPA termination would trigger an event of default and accelerate project debt in most cases. It is not clear whether contract termination payments would be enforceable if contracts cease to be valid.

Additionally, the Energy Regulatory Commission and the National Hydrocarbon Commission would be abolished, diminishing the system's operating transparency and competition, as there would be no independent arbitrators balancing market power among participants. Clean Energy Certificates would also be cancelled, eliminating one of the primary mechanisms to promote new clean power generation projects in Mexico.

The proposal would also bring Mexico's entire power supply chain -- generation, transmission, distribution and supply -- under CFE control, ending the autonomy of the country's independent system operator. CFE would dispatch its power plants ahead of cheaper, more efficient generators following an economic order that considers production costs (i.e. variable plus capital costs) instead of just variable costs. CFE would also be incentivized restrict access to the network, limit the permits of new private generation companies (GenCos) and limit investment in new transmission lines to connect private GenCos, exposing them to curtailment risk. This would likely displace private solar power energy and efficient gas-based power generation.

To support robust electricity production, CFE would need to accommodate project development at a pace sufficient to meet the country's demand. If the initiative passes, Fitch believes the system's capacity would be pressured beginning in 2024, and that private participation will be necessary to execute the needed new generation projects. Rate increases for end-users and/or government subsidies may be required to cover CFE's incremental operational costs.

CFE could set new contracted power prices that are substantially less than current prices, which, when combined with lower dispatch levels, will erode GenCo revenues. Currently, roughly 60% of the country's electricity comes from GenCos, mostly through efficient gas-fired facilities and renewable energy sources. Under the new proposal, private power generation would be limited to 46% of the country's load and must be sold only to CFE through bilateral contracts. Not only would this introduce uncertainty to future demand and pricing, it could also result in more volatile cashflows, undermining long-term debt issuance. Debt may need to be restructured according to the new contracts, and issuers could see increased debt costs.

Self-supply permits are unlikely to be renewed under the measure, and the spot market would most likely be dissolved, ending merchant revenues and further pressuring GenCos' financial position.

Cashflow might not be enough to meet the investment returns required by equity investors. Should projects end up in bankruptcy, equity capital would be wiped out, and lenders would take ownership of projects.

The proposal could further weaken Mexico's rule of law and may discourage future private investments in the sector. Foreign investors from countries with settled bilateral investment treaties and free-trade agreements with Mexico could challenge the law in international arbitration courts in an effort to protect their investments and receive monetary compensation.

Contacts:

Jesús Enríquez Torresdey
Director, Infrastructure and Project Finance
+52 (81) 4161 7006
Fitch Mexico S.A., de C.V.
Prol. Alfonso Reyes 2612, Piso 8
Edificio Connexity, Col. Del Paseo Residencial
Monterrey, NL, 64920
Mexico

Diego Rodríguez
Senior Analyst, Infrastructure and Project Finance
+52 (81) 4161 7063

Sarah Repucci
Senior Director, Fitch Wire
Credit Research & Risk Analytics
+1 212 908-0726

Media Relations: Jaqueline Carvalho, Rio de Janeiro, Tel: +55 21 4503 2623, Email: jaqueline.carvalho@thefitchgroup.com

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