Power, pesos and pricing

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For owners of independent power projects (IPPs) in Mexico, life is very good. Their main customer, the state-owned Comisíon Federal de Electricidad (CFE), pays its bills on time, and refinancings of existing assets have been coming through at very slim margins. Furthermore, with one eye on the boom in equity chasing infrastructure assets, some owners have decided to sell in what is very much a sellers' market.

The first assets to change hands, if only as part of a wider portfolio, were those of InterGen. Since then, Alstom has sold its interests in two petcoke-powered projects to AES, while EDF has announced that it wishes to sell its substantial portfolio in the country as part of its strategic reorganisation: The EDF assets have apparently attracted interest from US private equity firms.

The first three sales say as much about the changing priorities of the sellers as they do about the market. InterGen was sold after its owners, Shell and Bechtel, grew weary of its demands on cash, and Alstom has wanted to exit the business of owning power plants for several years. EDF has a much greater interest in becoming a European mega-utility than a global IPP.

But two other indicators demonstrate the sector's allure more convincingly. The first is that Conduit Capital, a developer of small power projects in Latin America and the Caribbean, is close to lining up a buyer for its stake in the Mexhidro small hydroelectric portfolio, as part of a wider process of realising the investments of its two Latin power funds. The Mexican assets, for which Enel is understood to be the leading bidder, have apparently fetched "staggering multiples," according to one banker familiar with the process.

The sales effort, to be conducted through BNP Paribas, is part of a wider process of realising investments in Conduit's first two Latin American Power Funds. But the fact that Conduit is likely to look for a buyer for the Mexhidro portfolio separate to the rest of its portfolio, which includes Termotasajero and Jamaica Power, indicates the premium that Mexican assets are commanding.

The second indicator is that Iberdrola managed to close a non-recourse financing for its Mexican independent power business with a margin priced at a very small premium to the European parent's corporate borrowings. The Ibermex financing is the strongest sign yet that Mexican power has gone from being the preserve of a club of developers to full-fledged corporate finance.

Iberdola takes it off

Ibermex is the culmination of Iberdrola's long-term project to make its Mexican assets self-supporting. The Spanish developer had mixed fortunes in putting together project financings that would be acceptable to multilateral lenders and cost-effective at the same time. But in the process it was able to build up in-house expertise and build projects that were economically efficient rather than pleasing to lenders. Even where Iberdola did raise project-specific debt, it would usually provide a corporate guarantee to this, in part to keep financing costs to a minimum. It also bought Enertek, the first large-scale cogeneration project in Mexico, from AEP and Alfa in 2001. The purchase marked its entry into the Mexican generation sector.

Iberdrola's director of energy management, Federico Carranza, was part of the team that developed Enertek at CSW, which AEP subsequently bought. Carranza recalls the diesel tank that project lenders required as back-up to the 120MW gas-fired project's fuel supply, and which has not to date been used. CSW had to fund construction of the asset with intercompany loans while project lenders worked through their issues with the project.

Iberdrola has long sought to unwind the series of project-specific loans that it has raised or assumed. It made a serious attempt to put together a portfolio deal in 2002, but faced problems with GE and Alstom turbine technology and its own lack of operational experience. More generally, combining a disparate set of operating subsidiaries into a single portfolio is complex – and is complicated by Iberdrola's success in winning bids for new capacity.

All of its almost 5,000MW in capacity, bar Enertek, has been built from scratch, and it is now the largest generator in Mexico. Roughly 90% of the portfolio's revenue comes from long-term power purchase agreements with the CFE, and Iberdrola is operating the portfolio in-house. Thus, the portfolio's financing could be presented to banks as a blend of the credits of Iberdrola and the CFE, both of which have strong followings among banks.

The sponsor and lead banks Citigroup, Calyon and BBVA put together an information memorandum for a $1.7 billion financing in June 2006, and signed documentation by December 2006. The financing features little sponsor support, an amortization profile that leaves 50% of the debt outstanding in year 10, pricing of below 75bp over Libor, and fees and other costs of less than 1% of the total amount.
Ibermex, as the portfolio is known for short, should be regarded more as a corporate financing, given its limited amortisation, debt/Ebitda ratio (less than 5.5x), and flexibility with respect to portfolio additions. Of the total debt, $500 million could be refinanced in the near future with a long-term bond issue, denominated in dollars, in the Mexican market.

Single-asset fortunes

The most recent refinancing, for the Termoelectrica del Golfo (TEG) petcoke-fired project, is a little smaller, yet equally useful in highlighting the improvement in conditions in the market. BNP Paribas is close to finalising a roughly $250 million package that would retire multilateral debt, cut debt margins, lower the amortization burden, and benefit from AES' recent acquisition of both TEG and its sister project Termoelectrica del Peñoles.

The refinancing is likely to have a 14-year tenor, a substantial balloon payment at maturity, and pricing of around 110bp over Libor, or half the original financing's 225bp margin. The 230MW project sells power to Cemex, and is one of the largest plants to sell power to large industrials in Mexico. It should, by rights, have a number of imitators.

Such plants enjoy a compelling rationale: the Mexican government has usually required large industrial enterprises to pay considerably more for their power than its cost, with much of the difference going to subsidising residential users. While developers and lenders in the country think that greater clarity in CFE's tariff structure would be better for credit analysis, and would ultimately make deregulation easier, this disparity does make for opportunities for developers pitching industrials.

These self-supply projects are so called because, to conform to the letter of Mexican laws, the offtaker must own an at least nominal stake in the project company. Mexhidro, TEG, TEP and the proposed La Ventosa wind project are all examples of the project type, and all share one common characteristic – cheap (or free) fuel. "I've heard people complain about the premium that industrials pay for power, but I've never seen a clear-cut case of them benefiting from more expensive fuels."

Even where the fuel is free, such as for wind, the CFE may charge producers a premium for the power they require to meet customer obligations when wind levels are low. The operation of the renewable energy bank has attracted some criticism from developers, since it favours those producers that call on it less frequently, such as hydro producers. Mexhidro, for instance, has found the system to be workable, but no wind projects have yet succeeded in winning financing.

The most far advanced wind project – EDF Energies Nouvelles' La Ventosa – has signed a satisfactory power purchase agreement, with Walmart Mexico, but has struggled to line up a turbine supplier. Other developers, including Sempra, with a project that would sell into the US market, and Iberdrola, which like La Ventosa would be based in Oaxaca, are much less well advanced.

Local heat and national heat

Oaxaca, home of Mexico's best wind resource, presents its own challenges to developers. The political situation in the state has been notably unsettled for over a year, and disputes between parties and factions have a habit of upsetting infrastructure investments. Conduit has long wanted to add to its hydro portfolio in the state, but has found pursuing the project to be dangerous to its staff at the project site. It has now put this project on hold.

State-owned oil company, Petroleos de Mexico, or Pemex, faces similar problems with political violence. It has experienced a number of attacks on an oil pipeline, including explosions in Queretaro and Guanajuato. The attacks, for which a group called the People's Revolutionary Army has claimed responsibility, have disrupted production at several multinationals.

The attacks have not directly harmed the operations of foreign gas or power project operators, but they have dealt a further blow to the prospects for greater outside participation in Mexico's oil and gas sector. The multiple service contracts, which were designed to attract outside exploration expertise to the country's gas sector, have not been a success, according to Jaime De La Rosa, who heads the energy industry's lobbying association, AMEE.

Nevertheless, there are opportunities for small-scale oil and gas projects in Mexico, since in 2006 both Banco Santander and Nord/LB closed deals with Pemex as a counterparty. Santander arranged an $89 million loan for Air Products and Grupo Infra's Jujo-Tecominoacán nitrogen project. This project, which will supply Pemex' extraction efforts 90 million cubic feet per day, is the subject of seven-year debt with a 175bp margin postcompletion. Its most notable feature was its being signed and negotiated with a regional Pemex office.

Nord/LB's $80 million loan for the Green Energy Libramiento project has a slightly longer tenor, at construction plus ten years. The sponsors of the project are Green Energy (25%), a Mexican developer, and Conduit Capital (75%), and the project is designed to relieve pipeline congestion near Queretaro, and improve operational performance at InterGen's Bajio project, and its associated pipeline and compression equipment. The loan featured pricing, according to sources close to the transaction that is slightly higher than the contemporaneous nitrogen deal, but a prospective refinancing is likely to cut the margin below that level.

Mexico's population has traditionally been more hostile to outside involvement in oil and gas than to its involvement power, although opposition politicians during the Fox administration attempted to interfere with the CFE's IPP programme. But the country enjoys 40% reserve margins (the difference between average demand and nominal installed capacity), and the CFE is comfortable enough with its current resources to delay new IPP bids until 2008.

The oil and gas sector lacks this luxury. According to Mexico's secretary of state for energy, Georgina Kessel, speaking at the roundtable, it has sufficient reserves for another 9.3 years of production. Kessel speaks of "providing state energy companies with the technology and resources necessary to improve production," but stresses that improving corporate governance, rather than outright privatization, is the preferred solution of the Calderon administration.

Bankers active in Mexico are inclined to play down the low-margin refinancing opportunities in power, and play up the greater business that the country's toll roads programme has to offer. Open a conversation speculating on the likely winner of the EDF Mexican auction process, which could bring the seller roughly $900 million, and most bankers will speedily move on to the forthcoming privatization of FARAC, a toll road trust that may fetch $4 billion from global infrastructure funds.

The Peso powerhouse

Bankers like to mention FARAC because any debt package backing a purchase will soak up a large proportion of the lending capacity that banks assign to Mexico. Coupled with additional greenfield toll concessions, which run from $200 million to $800 million each, and banks may be wary of lending money to Iberdrola Mexico at a mere 30bp premium to the corporate parent.

But mention the possibility that, like Ibermex, some of a borrower's requirements might come from the domestic capital markets, and an international lender becomes more nervous. It can be cheaper for a Mexican borrower with dollar revenues to borrow in Pesos and swap back into dollars.

Some of this advantage comes from withholding taxes on foreign lenders, which AMEE is lobbying to have reduced or removed for long-term debt. The tax treatment of projects has also prevented deals from reaching close. InterGen wanted to follow up the 2006 Nord/LB and BNP-led refinancing of its Bajio plant with a similar exercise for its larger La Rosita project. According to bankers familiar with the process, this had to be pulled after changes to the plant's tax treatment made a refinancing uneconomical.

But at present the peso swap market has an estimated capacity of $5.2 billion and daily volumes approaching $500 million. Mexican lenders have still exhibited some nervousness when confronted with construction risk, which has provided aggressive lenders such as Santander with copious opportunities.

The best gauge of lender appetite for Mexican power will be the EDF Mexico acquisition financing. Market rumour has the shortlist whittled down to three unnamed bidders, among which an infrastructure fund and a Japanese trading company are understood to be prominent. Japanese buyers have enjoyed considerable success in buying up portfolios of contracted assets in emerging markets, in particular the Mirant Caribbean and Philippines generating facilities.

But the price advantage of using JBIC debt, which has to date been decisive, may not apply in Mexico. An infrastructure fund buyer with a determined bank following may get pricing nearer to the TEG refinancing than to typical emerging markets debt. This would prove, as well as FARAC would, that Mexican assets command comparable valuations, and debt terms, to developed market infrastructure.