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Break out

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The Mexican electorate goes to the polls on 2 July, and the United Mexican States' elections are still too close to call. The elections will decide the holder of the presidency as well as the composition of the country's congress. The result offers the hope of a loosening of the states' control over Mexico's energy assets.

The collision of high-level politics and infrastructure development is particularly important, since financing activity in the Mexican energy market has been particularly torpid of late. Moreover, the recent leftward swing in voter sentiment across the continent is making lenders and sponsors nervous. President Morales in Bolivia recently did what many observers expect Venezuela's Chavez to do – expropriate foreign assets.

Mexico is a more prosperous country than Bolivia and, moreover, has maintained reasonably tight control over its energy assets, oil and gas in particular – a cultural legacy of its revolution. But debate within Mexico over reform of the state power and oil and gas monopolies, and the involvement of the private sector in these markets is still an important issue.

Energy security, for instance, has become as important a topic of public debate in Mexico as it has in the US. Mexico has long been able to rely on Petroleos de Mexico (Pemex) to make up the bulk of its production, and Pemex has long been the warhorse of the Mexican Hacienda (treasury). But Mexico is only slightly insulated from higher global prices by its domestic price regulation, and the country's oil industry is tightly intertwined with national pride.

The regulation of natural gas and electricity, while of lesser symbolic significance, has also become a key means of differentiating the candidates. The positions of the main presidential candidates – from the right, left and center – mirror the debates that have been taking place within congress during the administration of President Vincente Fox.

The president's yen

The above point is worth noting. Whether Felipe Calderon, the candidate of the centre-right PAN, Roberto Madrazo of the centrist PRI, or Andres Manuel Lopez Obrador of the centre-left PRD wins, they will likely not enjoy an absolute majority in congress. Thus, whatever view they have of the appropriate regulation of the energy industry, this will be tempered by the need to accommodate opposition lawmakers.

In this respect, a Calderon administration would continue the wary co-existence of the Fox administration with congress, albeit with Calderon's greater experience as a congressman. Madrazo, on the other hand, benefits from PRI's imposing structural advantages in congress, although the PRI, which ran Mexico virtually unopposed for decades, is split on energy reform.

The business community's clear favourite, and the most obvious voice in favour of greater deregulation in energy, is Calderon, who is both a member of Fox' party and his preferred successor. Calderon has run a much better campaign than many observers had expected. In particular, notes Gustavo Almaraz, of lobbying firm Grupo Estrategia, Calderon has tapped into an undercurrent of unease within Mexico's middle classes at unrest both within Mexico and elsewhere in Latin America.

At present, Calderon and Lopez Obrador are essentially tied in first place, as the latter's lead fell victim to his non-appearance at an initial debate and the former's canny campaigning. Calderon has lost much of his lead in the polls however, and a second debate, this time attended by Lopez Obrador, did not move the candidates' numbers much. The prevailing wisdom holds that snagging the waning Madrazo's supporters will be the key to victory.

The upheavals of Venezuela and Bolivia are unlikely to be repeated in Mexico, providing, qualifies Almaraz, that the winner of the presidential vote gets a margin above 5% over the second-placed candidate. But even if the leftist Lopez Obrador wins, a wholesale renationalisation is unlikely, and his room to manoeuvre in congress, where a block on energy reform attracts support only from the PRD and small sections of the PRI, is slim.

Energy reform

The agenda for the reform of the country's energy sector remains much as it was during Fox' administration. This agenda has its adherents within the management of Pemex and the Comision Federal de Electricidad (CFE), the electricity monopoly, and SENER, the energy ministry. At its heart lies granting greater financial independence to Pemex and autonomy to its management, and allowing greater private investment in the two.

Of the position papers put together by the three candidates, all of them would allow for greater operational autonomy to government-owned energy, and Calderon's would allow them a measure of tax autonomy. Madrazo and Lopez Obrador both produce noises about developing alternative energy sources, and Calderon mentions public-private participation in petrochemicals and refining, as well as municipal power production.

Within the reform agenda are major and minor structural reforms. These largely consist of the above, plus some concessions for marginal fields, some private sector involvement in deepwater exploration, and a strengthening of the energy regulatory commission (CRE, according to its Spanish initials).

According to Alejandro Dieck, undersecretary of planning and technological development at the Ministry of Energy, the ability of outside participants to participate in the sector beyond 2006, particularly through PPP-style structures, should be greater, and the minor slate of reforms should be possible. Above the more major reforms, those that would require a stronger congressional consensus, there is a large question mark.

Industry's reform suggestions are more extensive, but its leaders are cautious. According to Eduardo Andrade, the head of the Mexican Energy Association (AME), notes that his members would be interested in a greater level of force majeure protection for independent power producer equity, since at present the Mexican government can buy out a concession beyond that concession's debt's 15-year term at half price.

Andrade's view is that reform will be at root a product of the government's fiscal priorities. Pemex supplies 38% of tax receipts, and what happens to Pemex depends in large degree on how the government's ability to collect its taxes. Its ability to maintain the present level of receipts from Pemex will depend on Pemex becoming more technically adept in exploiting marginal reserves.

Mega projects, micro steps

An alternative method of increasing receipts, and ensuring Mexico remains self-sufficient, will be to bring more petrochemical and refining capacity on-line. High feedstock – natural gas and crude – prices mean that Mexico has little incentive to develop capacity when producers in the Middle East can do the job much more cheaply.

Refining projects, on face value, look like a better prospect, if only because they enjoy so much public support. The presidential candidates have been engaged in a furious bidding war – Calderon wants two new refineries, Lopez wants four, and Madrazo has countered with a call for six. Pemex, on the other hand, is believed to be planning for one, and the proposal for a refinery at Panama, which originated in the current president's office, is good, says Andrade, mostly as a source of work for consultants.

But there are promising developments in the cross-border market. A clean fuels refinery at Yuma in Arizona and a pipeline project to be developed by Valero are both likely, in part, to serve the Mexican market, and have been made possible by recent rulings from the Secretary of Energy. Likewise, maintenance of pipeline infrastructure will also become a little more open to outside investment, and 1,950MW in transmission capacity will be bid out if Mexico is to make use of wind resources in its south-east.

The CFE continues to stick to its timetable of bids in the face of reserve margins as high as 40% (albeit with much of the generating fleet in a rather advanced condition) and investor concerns about the viability of IPPs' regulatory standing. 2005-14 features 11,730MW in combined cycle additions, 2,244MW in new hydro, 648MW in new coal, 504MW in new gas simple cycle, 70MW in wind and geothermal, and 5,698MW in capacity to be fuelled at the developer's choosing.

Forthcoming tenders for independent power projects will be few – only the Norte and Norte II combined cycle turbines, each of 441MW are out to bid imminently. The remainder of power projects, including a 746MW hydro project called La Yesca, conversions at San Lorenzo and Tuxpan, and the 85MW wind project La Venta II, will be procured as Obra Pública Financiada (OPF) projects. These feature construction risk, and CFE payment risk, but not operational, fuel or dispatch risk.

LNG – CFE takes over

The CFE is also taking the lead in developing new liquefied natural gas importation terminals. Mexico is currently a small net importer of gas, but SENER's figures suggest that this imbalance is likely to reach up to 3.5 billion cubic feet per day by 2013. And so the lead in this effort will consist of the Manzanillo project, on the country's west coast, a 500 million cubic feet per day project, as well as associated natural gas transport into Guadalajara, and a repowering and conversion of the Manzanillo heavy fuel plant.

Procurement for the complex will take place under a number of separate frameworks – the repowering, for instance will use the public works law, but the purchase of LNG, the construction of the terminal and the additional transportation project, take place under the acquisitions and services law (LAASP).

This law, which has a provision that allows the public partner to terminate a concession under ill-defined circumstances, has been a source of concern for developers. It is notable that the only existing LNG concession, for Shell's Altamira project, was funded on balance sheet. Similar larger players, in particular those that can live with these termination provisions, will be the major takers for Manzanillo unless the CFE can arrange for the loophole's closing. The officials canvassed by project finance are optimistic that this is possible – as they have been for the last several years.

But LNG is key to avoiding the disruptions at Pemex that would be required to increase gas production. The most recent scheme for getting round restrictions on outside activities in upstream – the multiple services contract – has been controversial and a little unwieldy. The Mexican equivalent of the US' General Accounting Office has demanded some minor changes to the way these contracts are presented, including the use of unit prices for public works, according to AME's Andrade.

As the Manzanillo tender shows, the CFE has taken over responsibility for importing gas, after it resumed responsibility for supplying independent power projects with gas. For a while Pemex had wanted to assume responsibility for supplying power projects with gas, but this turned financing these projects into a protracted and difficult process – at least one project financed under this framework could not fund.

The take-out that wasn't

Lost in such debates is the continued willingness of banks to finance projects in the country. Five years ago, when banks were much more active in the market, lenders assumed, on the back of sovereign upgrades from the ratings agencies, that construction deals would be refinanced in the capital markets. For various reasons, as Nord/LB's head of corporate and structured finance in New York, Bruno Mejean, explained, such refinancing as has taken place has happened through banks.

"We've seen several deals refinanced in the bank market, and it now seems that even if monolines became involved in the Mexican power market they would be wrapping bank debt, as has happened elsewhere, rather than bonds," says Mejean. "Lender interest is such that sponsors can raise very long-dated money."

The best illustration of this is the partial refinancing of InterGen's Bajio project, led by BNP Paribas and Nord/LB. The two leads refinanced senior debt from the Inter-American Development Bank (IDB), as well as the sponsor's contingent obligations to the project. The financing closed in March 2006, and comprised a new $137 million senior term loan, a $27 million debt service letter of credit, and a $20 million letter of credit backing the project's obligations to the CFE under its power purchase agreement.

The main differences in the refinancing are that the two letters of credit are no longer backed with guarantees from InterGen or its shareholders, and a further liquidity letter of credit, which still features an InterGen guarantee, has been reduced from $70 million to $20 million. The sponsor has not taken out any equity, and the project's $215 million loan from US Ex-Im remains in place. The Ex-Im loan, and the repaid IDB loan both closed in July 2000.

Structuring the new deal so as not to disturb Ex-Im's position, the PPA letter of credit is subordinated to the other facilities. This letter of credit, therefore, is priced at 350bp over Libor. The other two new loans, however, are priced at 125bp until 1 December 2009, and 150bp thereafter, about half the original margin on the IDB A/B loans. This, if nothing else, is one reason why the bank market remains a good option for refinancing.

The other reason is a little more prosaic. The power purchase agreements attached to the generation of IPPs built in the early part of this century tend to feature capacity payments that are highest early in the life of the project. Thus, holders of longer-dated bonds would need to depend on variable power payments and low capacity payments for repayment later on in the bonds' life.

So, while Bajio has been operating for three years, and has long-term contracts with the CFE for 500MW of its 600MW of capacity (it buys the rest until 2007), it was the product of intense bidding of that period. Other producers, such as Japanese or Spanish corporates, that bid on the basis of lower cost of capital rather than aggressive contracts, might have more luck.