October 4, 2011

Comments from Germany on the Approval by Mail: Mexico Renewable Energy Program, Proposal III

Dear Patricia and CTF-Team,

pls find attached our detailed comments. We would like to stress that in principle we are prepared to approve the project proposal, but are seeking clarifications concerning a number of issues.

Kind regards
Annette

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Comments on CTF Public Sector Proposal
“Mexico – Renewable Energy Financing Facility (REFF)”

Financial Volume	70 million USD CTF Loan, 70 million USD IDB co-financing Loan 70 million USD NAFIN local contribution 690.000 USD CTF grant
Purpose of the program	Establishment of a Financing Facility to provide competitive loans and contingency credit lines for renewable energy projects in Mexico

A General Comments on the Project

We welcome this proposal and would generally be happy to support it, provided that some further issues are clarified.

The program goal is to contribute to Mexico’s drive to increase the share of Renewable Energy (RE) sources in its overall generation and to assist Mexico in its commitment to reduce GHG emissions. This would be achieved by filling a financing gap for renewable energy projects through providing competitive loans and credit lines to cover cash flow deficits during the life of the project to project developers. In many cases renewable energy projects in Mexico still lack access to appropriate financing options, due to the high initial investment cost, the banks' apprehension to develop a technology which is comparatively new for Mexico and proven experiences as well as regulatory incentives are still lacking.

However, the envisaged projects can be expected to support the current situation, where – due to the lack of a corresponding grid – the renewable energy capacity will probably be used not to feed into the grid but to provide electricity to larger enterprises. Although it seems reasonable that financing under these conditions (matching interests between the Wind-Energy investor and the large customer) is more challenging, many argue that fundamental reforms of the Mexican electricity sector are needed. We think, it is important to **elaborate more on the question to what extent the proposed project will facilitate the fundamental reforms or the structural change of the Mexican electricity sector**. Similarly, the proposal would benefit from additional thoughts about whether **long-term structural advantages for the population** are expected, what these are and how they will materialize. **Are project developers actually obliged to undertake additional community development measures** (as mentioned in Appendix 2) or is that merely optional?

Furthermore, the estimated investment cost range of **2 to 2.5 Million USD per MW seems on the high side**. Costs above 2 Millions would require explanation from our point of view.

On top of providing attractive loan financing, the proposed CTF program also provides grant components for studies in the areas of knowledge management as well as local social and gender impacts. Protest of the local and indigenous population has frequently been an issue in Wind power projects in this regions in Mexico. It is less clear from the proposal, how the grant components are really integrated/connected to the provision of the individual loans. **Will the results of the studies be included into the individual final loan agreements as conditions** for the loan to be paid out?

B General Comments on the Financing Terms

The terms of the CTF loan are

- Interest : 0,75 %
- Maturity: 20 years
- Grace: 10 years

These terms reflect the harder concessional terms as predetermined in the standard conditions. Still, they offer very attractive financing to the projects. It would be desirable to **be more explicit in justifying these highly concessional terms**: The proposal simply refers to the standard-conditions. But very concessional terms are to be justified in terms of the added value that the CTF contribution is expected to generate, which would not occur in the absence of the CTF contribution. One example could be a large leverage of additional external funds, or IDB funds. One other would be a special contribution to a fundamental structural change of the Mexican electricity sector (see section "General Comments on the Project"). If pooled together CTF and additional external funds would still lead to an attractive average interest rate for the final borrower.

C Investment Criteria

Potential for GHG Emissions Savings

The REFF is expected to finance a capacity of 1GW in renewable energy projects. The operation of these projects would lead to a reduction in emissions of 2.0 Mt CO_2e per year, or 40.0 Mt CO_2e over the course of 20 years.

Cost-Effectiveness

The cost effectiveness of the REFF is estimated to be 1.75 USD of CTF funds per ton of CO_2e abated, considering 40.0 Mt CO_2e over a lifetime of 20 years, and USD 70 M of CTF funds.

Demonstration potential at scale

It is expected that the REFF will increase the availability of local financing for renewable energy projects, especially for wind power projects. Through the creation of the REFF, the IDB seeks primarily to leverage the CTF funds and to scale up investments in RE projects. The increase in the number of projects will also demonstrate their viability and indirectly contribute to the development of capacity within a financial sector increasingly familiarized with RE project risks.

Development Impact

The main development impact of the renewable energy power plants lies in their contribution to reduce GHG emissions as well as to energy security and in particular to the reduction of the exposure of the electricity system to fossil fuel price volatility.

Smaller development impacts include the provision of employment opportunities, especially, but not only, during the construction phase of the renewable energy plants and income derived from the rental/leasing of the land affected to the power plants. The Environmental and Social Management Report prepared for this project shall include provisions to ensure that lease prices have been determined through a fair process and are in line with market comparators.

The **CTF-Team is to be commended** for including a **social and gender impact study** in the proposal. Nonetheless, we would be interested in learning how the results of the study will relate to the overall project design, including indicators for M&E. And as has been pointed out above, integration with the loan agreement also poses questions.

Implementation Potential

The analysis carried out by IDB showed that the National Mexican Development Bank NAFIN has the ability to execute the REFF. With a technical cooperation activity funded with CTF resources included in Proposal II, IDB is supporting NAFIN's institutional capacity to prepare and monitor RE operations, as well as to handle the environmental and social risks.

Additional Costs and Risk Premium

Renewable Energy projects in Mexico in many cases still lack access to appropriate financing options, due to the high initial investment cost, the banks' apprehension to develop an in Mexico still relatively new technology without proven experiences and the lack of regulatory incentives.

Some resident foreign banks have been active in financing wind power plants, seemingly on account of their matrix' business ties with the partners in the development (Bancomer, Santander, Citibank) but the rhythm and scale of RE investments would vastly improve if financial resources at competitive rates were made available to developers.