



**Inter-American
Development Bank**

**IDB PUBLIC SECTOR
CTF PROPOSAL**

**Mexico Renewable Energy
Program, Proposal III**

Mexico Renewable Energy Program, Proposal III
Proposal for Submission to the CTF Trust-Fund Committee

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<i>Name of Project or Program</i>	Mexico Renewable Energy Program, Proposal III
<i>CTF amount requested</i>	<p>USD70M public sector loan for the Renewable Energy Financing Facility (REFF)</p> <p>USD260,000 grant for IDB-executed knowledge management program</p> <p>USD320,000 grant for IDB-executed technical cooperation on local social and gender impacts</p> <p>USD29,000 budget for implementation and supervision of knowledge management and technical cooperation activities</p> <p>TOTAL: USD70,609,000</p>
<i>Country targeted</i>	Mexico
<i>Indicate if proposal is a Project or Program</i>	<p>Public Sector Program</p> <p>The development of renewable energy in Mexico is being supported by both public and private sector activities at the IDB and private sector activities at the IFC.</p> <p>The Program incorporates several public and private sector components, which are being developed in parallel to complement and build upon each other with a view toward transformation of the renewable energy market in Mexico. The overall program is being submitted to the CTF Trust Fund Committee in four proposals.</p> <p><u>Proposal I</u> was approved on May 11, 2009, by the CTF Trust Fund Committee and allocated USD 15.6 million for the first intervention in this Program, the joint IFC/IDB <i>Private Sector Wind Development</i>.</p> <p><u>Proposal II</u> expanded upon the programmatic approach presented in Proposal I and was approved on November 17, 2009 by the CTF TFC. It allocated USD 53.377 million for an envelope of private sector projects and public and private sector technical assistance activities.</p> <p>Proposal III, described herein, seeks funding for a public sector Renewable Energy Financing Facility, and additional technical cooperation activities.</p> <p>Proposal IV, to be submitted at a later date by the IFC, will seek funding for private sector projects within the Program.</p>

ACRONYMS AND ABBREVIATIONS

CCLIP	Conditional Credit Line for Investment Projects
CFE	<i>Comisión Federal de Electricidad</i> (Federal Electricity Commission)
CO ₂ e	carbon dioxide equivalent
CTF	Clean Technology Fund
GEF	Global Environment Facility
GHG	greenhouse gas
GoM	Government of Mexico
IBRD	International Bank for Reconstruction and Development
IDB	Inter-American Development Bank
IFC	International Finance Corporation
IIE	<i>Instituto de Investigaciones Eléctricas</i> (Electric Research Institute)
IP	Investment Plan
M	million
MDB	Multilateral Development Bank
Mt	million tons
MXN	Mexican pesos
NAFIN	Nacional Financiera, Sociedad Nacional de Crédito
RE	renewable energy
REFF	Renewable Energy Financing Facility
t	metric ton
TFC	Trust-Fund Committee
USD	US Dollars

PROGRAM DESCRIPTION

Fit with Mexico's Country Investment Plan

1. On January 27, 2009, Mexico's Country Investment Plan (IP) was endorsed by the CTF Trust Fund Committee (TFC). Mexico's IP described the country's greenhouse gas (GHG) emissions profile and indicated that the development of renewable energy sources was a key strategic area for CTF resources. An initial analysis determined that a CTF renewable energy program could result in a reduction of around 1.8 million tons of carbon dioxide equivalent (Mt CO₂e) /year at an abatement cost between USD 31/t CO₂e and USD 38/t CO₂e. The CTF IP proposed an overarching strategy for the development of renewable energy, involving: (i) establishing a financing facility in a local infrastructure bank to leverage funds and scale-up investment in wind and small hydro power plants; (ii) improving the regulatory environment in favor of renewable energy projects; (iii) undertaking a comprehensive assessment of opportunities for attracting carbon finance for the renewable energy and energy efficiency sector; (iv) supporting local renewable energy research centers for demonstration of technologies and (v) leveraging IDB loan/guarantee support to the private sector to facilitate implementation of RE projects.
2. The first operation under the IP, the joint IFC/IDB Private Sector Wind Development Program ([Proposal I](#)), for a total of USD 15.6M, was submitted by IFC and approved by the CTF Trust Fund Committee on May 11, 2009.
3. A [second proposal](#) for a total of USD 53.377M, submitted by the IDB, was approved on November 17, 2009. This proposal expanded upon the programmatic approach presented in Proposal I. The core of this proposal was the allocation of USD 50 million of CTF capital for an envelope of private sector renewable energy projects in Mexico. The proposal included in addition USD 1.54M of CTF grants for the following set of public and private sector technical cooperation activities:
 - Assessment, capacity-building and development of programmatic CDM and other Carbon Finance opportunities (USD 800,000).
 - Biomass, geothermal and cogeneration studies to support the design of the regulatory framework (USD 240,000).
 - Technical Cooperation for strengthening NAFIN's capacity for renewable energy financing and support for project preparation grants (USD 300,000) (see §35).
 - Study on the economic and social benefits associated with investment in the wind power sector (USD 100,000) (see footnote 2 below).
 - Development Plan for Local Communities (USD 100,000).
4. With the CTF resources from both proposals I and II, blended with their own resources, IDB and IFC jointly provided financing to two large wind farms, Eurus and La Ventosa.
5. Following from the IP and Proposals I and II, the IDB is presenting Proposal III of this comprehensive public/private program designed to demonstrate renewable energy as a commercially attractive, proven, and reliable source of power and to stimulate transformation of the energy sector in Mexico. Whereas Proposals I and II sought to support the development of a few projects via direct financing by MDBs, Proposal III seeks to accelerate and scale-up the availability of finance to a larger number of projects, by engaging a key institution, namely NAFIN, a national development bank. This proposal includes as well a comprehensive knowledge management program and a study on local social and gender impacts.

6. Finally, IFC may submit a Proposal IV of the Program to seek approval for up to USD 15 million of CTF funding to fund one or more additional individual private sector projects.¹

7. Proposal III has three components: The Renewable Energy Financing Facility (REFF), a knowledge management program, and a study on local social and gender impacts. These components are described in the following sections.

Renewable Energy Financing Facility

8. The USD 70M REFF seeks to contribute to Mexico's drive to increase the share of Renewable Energy (RE) sources in its overall generation; to support the government of Mexico's (GOM) in achieving the GHG emission reduction pledged at Cancun 2010 to the UNFCCC participants; to introduce new financial instruments to facilitate private sector participation in RE in Mexico, complementing the role played by CFE; and to derive lessons learned that would be useful in the analysis of financial and regulatory instruments required to achieve the low-carbon development path to which the GoM is committed. These objectives will be achieved by filling up the existing financing gap for renewable energy projects through the provision to project developers of competitive loans and contingency credit lines to cover cash flow deficits during the life of the project. CTF concessional resources will leverage at least a similar amount from NAFIN's lending resources and a further similar amount from the existing CCLIP ME-X1010, hence combining for a total minimum amount of USD 210M. The REFF is described in more detail on the IDB's ME-L1109 Draft Loan Proposal (DLP) document, attached to this proposal.

Knowledge Management Program

9. As stated in [Proposal II](#), knowledge creation activities are occurring on the ground in Mexico: at the project sites, with the regulators, in research institutes, in discussions with the local population, while measuring migratory bird patterns, or in the board room of renewable energy developers. In order for this knowledge to spread beyond the locale in which it is generated, a robust knowledge management component, with a specific focus on wind power projects, is needed for capturing the knowledge and disseminating it within Mexico, through the IDB, and to the CIF Administrative Unit and the broader climate change community, including the UNFCCC.

10. The knowledge generated by the Program is expected to fall within five categories: regulatory, technical, environmental, social, and financial.

Regulatory knowledge

11. In order to take stock in the progress made so far in the Mexican regulatory framework for renewable energy under the self-supply modality, and to assist Mexico in the preparation of measures to improve the policy and regulatory framework for the development of projects under the independent power producer and small producer modalities, the IDB is requesting the CTF a grant of USD 100,000 to assist in the organization of a high-level conference, with the participation of international experts, federal and state government officials, members of Congress, representatives of public and private banks, developers, technology providers, and other relevant stakeholders.

Technical knowledge

12. In the area of technology development and transfer, the GoM, through the Electric Research Institute (IIE), has requested to the GEF a USD 5M grant, with the technical support of the IDB as GEF implementing agency, to carry out a technical cooperation program that would assist the development of new 1.2 MW Class 1A wind turbine technology to address the specific wind conditions of the

¹ The IFC is planning to submit an additional proposal for approximately USD 20M for one or more energy efficiency projects. The IFC was allocated a total of USD 50M in the Mexico IP.

Tehuantepec region and facilitate the development of a local supply chain to design, develop, construct, and maintain wind turbines in Mexico, with an emphasis in grid-connected distributed generation and in maximizing the industrial development co-benefits of wind power. This will leverage additional co-financing from IDB, the GoM and private sector, with the aim for supporting the creation of a competitive supply-chain and services industry in the wind energy sector for the production of electricity. The general objective of the project is to include Mexico as a key player in the world's wind energy market, expanding its wind generation capacity by enabling local development and implementation of wind turbine technologies, particularly for distributed generation. The specific objectives are to: (i) consolidate the human capacities and skills required for the design of state-of-the-art wind turbines for distributed generation; (ii) structure a value chain for the production of goods and services at the national level in the wind energy sector and consolidate the capabilities for manufacturing and assembling wind turbines for distributed generation; (iii) consolidate the technical capabilities for the operation, testing and certification of wind turbines for distributed generation with a high component of national technology; and (iv) support the development of a 1.2 MW Class 1A wind turbine for distributed generation and provide capacity building to promote wind power application through distributed generation by small power producers.

Environmental knowledge

13. The knowledge about the impacts of wind power projects on wildlife, and in particular on birds and bats, has significantly increased in Mexico over the course of the last years, and two significant studies are planned for 2012: (i) Firstly, with the support of a GEF grant implemented by the International Bank for Reconstruction and Development (IBRD, World Bank), the Energy Ministry will soon commission a Strategic Environmental Assessment, which will identify the risks and opportunities for the sustainable development of wind farms and their related infrastructures in the Isthmus of Tehuantepec, and (ii) the IDB is preparing a proposal to carry out, with its own resources, a regional study about the impacts of wind power projects on the avian fauna, which will identify best practices and lessons learned in Mexico and other countries. The IDB is requesting the CTF a grant of USD 50,000 to communicate the results of both studies in Mexico and internationally.

Social knowledge

14. As large wind farms start to operate in Mexico, their relationship with the local communities is a key issue to be analyzed and reflected upon, in order to derive best practices and lessons learned. The local social and gender impacts study described below includes knowledge management components for this purpose.

Financial knowledge

15. Last but not least, critical knowledge about financial mechanisms and about the roles of public and private financial institutions needs to be created and communicated, in order to help addressing the existing financing gaps for renewable energy projects. This component seeks to strengthen the knowledge and understanding of key stakeholders from the region, by (i) creating up-to-date knowledge that contributes significantly to the understanding of the importance of creating finance mechanisms to leverage funds for renewable energy projects, and (ii) carrying out relevant activities to disseminate knowledge on how to finance renewable energy projects. These objectives will be fulfilled by engaging relevant GoM ministries, national development banks, private banks, and project developers.

16. The type and depth of knowledge, as well as the strategies to disseminate it, will vary according to the knowledge needs, challenges and level of experience of the stakeholders to which this knowledge management approach is directed. This component will include a set of knowledge products, including (i) a minimum of two case studies from Mexico and another country in the region; (ii) a minimum of two technical notes on lessons learned from Mexico and another country; (iii) a minimum of one training

workshop, and (iv) a the production of a practitioner’s guidelines document. The IDB is requesting the CTF a grant of USD 110,000 to carry out these knowledge management activities on financial mechanisms and institutions.

Table 1. Summary of knowledge management program package

Component	Amount requested to CTF	Other amounts
Regulatory knowledge	100,000	
Technical knowledge		5,000,000 (GEF)*
Environmental knowledge	50,000	50,000 (IDB)
Social knowledge	(Included in social impacts study)	
Financial knowledge	110,000	
Total	260,000	

* This amount was already included on the Summary Table of Proposal II. Therefore, it is not included on Table 3 to avoid double-counting.

Local social and gender impacts study

17. The experience of the wind farm projects in the planning, construction or operation stages in the Isthmus of Tehuantepec shows that there has been an uneven distribution of benefits at three closely interrelated levels: between communities, among different social groups within the communities, and among genders within the communities. This study seeks to assess the needs of the communities and their members, analyze the distribution of benefits at these three levels, and suggest to relevant stakeholders possible ways to achieve a more equal distribution.²

Distribution of benefits between communities

18. In Oaxaca compensation from wind developers to communities for property rights, leasing and land access, as well as initiatives to invest in community development varies significantly from community to community. A unified approach in engaging communities in the region, and in particular *ejidos* and *comunidades*,³ is lacking. Uneven apportionment of benefits from wind farm investment has resulted in increasing social tension in the state of Oaxaca. This trend is likely to continue due to growing investment in the region. It is now imperative to better understand the roles of *ejidos* and *comunidades* in negotiations with developers for property rights, leasing and land access issues to help mitigate project and cumulative risks in the region. The IDB requests USD 200,000 of CTF non-reimbursable finance for a technical cooperation to create Principles for Community Engagement in Oaxaca.

Distribution of benefits among communities

19. Within communities, most benefits accrue to the individual shareholders of *ejidos* or *comunidades* or to private land owners, as a result of rental or leasing payments. In order to benefit the wider communities, wind farm developers and operators provide contributions for a range of community goods and services. There is, however, a lack of a clear framework to ensure that all these resources effectively contribute to the development of the communities. This component of the study will be carried out with the resources that were already approved by the CTF, as part of [Proposal II](#) (Community Development Plan component).

² The study on the economic and social benefits associated with investment in the wind power sector, which will be funded by CTF resources under Proposal II (USD 100,000), and will be part of a larger effort by the Energy Ministry (SENER), IFC, the Mexican Wind Energy Association (AMDEE), and a number of companies, will address the social benefits at the national level. There is therefore no overlap between these studies.

³ *Ejidros* and *comunidades* are the two collective ownership schemes in Mexico. The majority of the surface area with high-quality wind resources in the Isthmus of Tehuantepec corresponds to either of these schemes.

Gender distribution of benefits

20. Finally, there is a lack of understanding about the role of gender in the distribution of benefits and in decision-making, about what mechanisms can be used to ensure a more even distribution between men and women in the Tehuantepec communities, and about the relationship between gender issues and the region's development. The IDB is requesting a CTF grant of USD 120,000 to carry out this component of the study.

21. These three components will be carried in close coordination with each other, with the relevant agencies of the Federal and State governments in Mexico, and with IBRD, IFC, and other development agencies.

Table 2. Summary of Local Social and Gender Impacts Study

Component	Amount requested now to CTF	Other amounts
Principles for Community Engagement	200,000	
Community Development Plan		100,000 (CTF; already approved)*
Gender issues	120,000	
Total	320,000	

* This amount was already included on the Summary Table of Proposal II. Therefore, it is not included on Table 3 to avoid double-counting.

Financing table

22. Table 3 below shows the direct components of this Proposal III of the Mexico Renewable Energy Program.

Table 3. Direct and Associated Loans and Activities of Proposal III (USD million)

Description	CTF resources	IDB Group resources	Other resources	Total
Renewable Energy Financing Facility	70.000	70.000	70.000	210.000
Knowledge Management Program	0.260	0.050		0.310
Local Social and Gender Impacts Study	0.320			0.320
Implementation and supervision costs	0.029			0.029
TOTAL	70.609	70.050	70.000	210.659

FIT WITH INVESTMENT CRITERIA

Potential GHG Emissions Savings

23. The REFF is conservatively 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 CO₂e per year, or 40.0 Mt CO₂e over the course of 20 years.⁴

24. With emission reductions approximately equal to 0.3% of Mexico's current total annual GHG emissions, the mitigation potential of the REFF is high. The renewable energy technologies to be deployed are technically viable, and commercially available.

⁴ These figures assume a capacity factor of 42% and an emission factor of 0.547 MWh/t CO₂e

Cost-Effectiveness

25. 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

26. Scope for avoided annual GHG emissions. It is expected that the REFF will contribute to NAFIN and private banks in Mexico substantially increasing the availability of local financing for wind power projects, which in turn will lead to the financing and development of approximately 2GW of RE capacity by the end of 2015 (in addition to the 1GW expected to be financed by the REFF).

27. Transformation potential. This program combines CTF concessional resources (USD 70 million) with IDB and NAFIN loans, leveraging an additional (minimum) USD 140 million, to finance RE projects through direct funding to developers or through the provision of contingent lines that would cover cash flow deficits emerged during the life of the project due to lower than expected production, lower than expected official prices (to which energy prices are sometimes linked) and/or lower payments from the off-taker. 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

28. The main development impact of the renewable energy power plants lies in their contribution to energy security and in particular to the reduction of the exposure of the electricity system to fossil fuel price volatility. In a context of increasing dependence on imported fuels (Mexico imports both natural gas and coal), renewable energy also contributes to energy sovereignty. Another relevant impact at the national level is industrial development: experience in Mexico and beyond shows that a predictable demand for RE power plants effectively contributes to the creation of a domestic manufacturing capacity.

29. Renewable energy also has impacts at the local level. These plants provide employment opportunities, especially, but not only, during the construction phase. Although generation plants are capital-intensive factories and once constructed the number of workers directly serving production is relatively limited, the number of projects does imply a number of indirect job opportunities locally, especially significant when considering that a majority of those will be concentrated in relatively poor areas (Oaxaca). At this stage it is estimated in over 10,000 hectares the land occupied by the RE projects, and in some 7,000 the jobs to be created during the construction phase.

30. Another local social impact is the income derived from the rental/leasing of the land affected to the power plants. This income will accrue mainly to local collective ownership schemes (*ejidos* and *comunidades*), but also to some private owners. The Environmental and Social Management Report prepared for this project includes provisions to ensure that lease prices have been determined through a fair process and are in line with market comparators.

31. Finally, project developers complement their lease/rental agreements with other compensations, typically in support of municipalities and communities, and normally consisting of goods and infrastructure investments. Although it is often difficult to estimate or to monetize such contributions because they may not be made public and because communities lack incentives to make them so, they are smaller in size than the employment and rental income benefits. NAFIN will do its best efforts to gather information on such practices as projects progress.

Implementation Potential

32. The analysis carried out by IDB shows that NAFIN has the ability to execute the REFF: NAFIN is a national credit institution established to promote savings and investment and to channel financial and technical support for Mexico's industrial and economic development. IDB has a long history of relations

with NAFIN although centered in the more traditional support policy towards SMEs. NAFIN supports projects with private sponsors to reduce GHG emissions through a new Sustainable Climate Change Projects Unit, which has received technical assistance from the World Bank to develop a methodology and manuals to manage the risks associated with RE projects.

33. NAFIN is best positioned to leverage the resources from the Clean Technology Fund (CTF) with the resources of the existing CCLIP ME-X1010 and with its own funding to scale up the impact of the multilateral initiatives involved. NAFIN is a solvent institution with adequate risk management practices and the full backing of the GoM. In December 2010, its assets stood at MXN 299 billion, including a credit portfolio of almost MXN 123 billion. Net worth totaled MXN 16.3 billion. Over the past two years NAFIN increased its activity and expanded its balance sheet to counter the decline in economic activity due to the financial crisis, and yet managed to generate a net profit of MXN 1,040 million in 2010. Capital, cash, and reserves amount to a comfortable financial position.

34. Based on the Bank's recent institutional capacity assessments on NAFIN's structure and processes (2009) and based on the experience in executing the ongoing operations, the fiduciary analysis concludes that NAFIN's systems are adequate and reliable. The fiduciary management system of the federal entities is in fact solid and thoroughly regulated—in terms of both financial and acquisitions matters—with strong internal controls and with external controls of audit firms when projects include external finance. This program will use national systems only for the disbursement procedures, relying on well-proven NAFIN methodologies.

35. Finally, 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 (see more details on the enclosed ME-L1109 DLP document).

36. The Energy Regulatory Commission (CRE) has played a prominent role in the promotion and regulation of RE self-supply projects. Since 2001, when the first regulatory resolution for RE projects was issued, CRE has improved the regulatory framework. In 2008, the new Renewable Energy Law ([LAERFTE](#)) bestowed CRE with new powers, including a strengthened arbitration role between the public utility and self-supply projects. Finally, the CRE organized an *open season* process to finance the construction of a key transmission line linking the windy area located at the South of the Isthmus of Tehuantepec with the Northern part of the Isthmus where Mexico's transmission backbone is located, with the participation of both private developers and the public utility. CRE has already initiated the organization of new open seasons for the Isthmus and for other regions (Tamaulipas, Baja California and Puebla) with significant RE resources. Summing-up, CRE has the capacity to guarantee the development of RE projects under a predictable regulatory framework.

37. Insofar as the developers themselves are concerned, the experience shows that they have the required capacity to take their projects from the blueprint to the operating stages.

Resource mobilization

38. Using conservative estimates for a total of 1,000 MW of generation capacity installed, the USD 210 million of the REFF would mobilize a further amount of between USD 1,190 and USD 1,540 million to cover the investment costs of the projects, assuming USD 2 to USD 2.5 million per MW and a 30/70 equity to debt ratio.

Additional Costs and Risk Premium

Introduction

39. Power generation plants can be owned and operated either by Comisión Federal de Electricidad (CFE, the public utility) or by the private sector. Private sector projects fall in turn into three modalities:

independent power producer (IPP, under a tender-based system), small producers (capacity under 30 MW), and self-suppliers. IPPs and small producers sell all the electricity they generate to CFE.

40. CFE has been investing in geothermal and wind power projects, either as utility-owned or through IPP contracts. The development of these projects, however, has been relatively slow, on account of their capital-intensive nature and the requirement that any public sector investment generates a minimum 12% internal rate of return and positive cash flows every year.

41. The [LAERFTE](#) law sets favorable conditions for the development of RE small producers. However, the required complementary regulatory and programmatic mechanisms have not yet been developed and virtually no small producer project is in operation.

42. In this context, private power developers are turning to the self-supply market, which allows a technological leader (a generator) and an energy-intensive manufacturing company (a consumer), often in different locations, to pool their capital resources and seek to finance the joint-venture. Self-supply projects take advantage of recent changes to the regulatory framework, which allow for an energy bank, capacity contribution recognition, and reduced and simplified wheeling charges.

43. Despite regulatory and policy progress over the past years, self-supply projects still face a number of barriers that increase project risks and costs:

Cost and risk premium

44. Firstly, developers depend on the off-takers' credit qualifications, and the role of the public utility (CFE) as the backstop off-taker in cases of breach of contract by the off-taker lacks clarity.

45. Secondly, in the absence of an open market for contracts between generators and consumers, project developers need to find and negotiate with individual potential consumers, with high transaction costs, especially when projects require a set of medium-sized consumers.

46. Finally, RE projects lack access to appropriate financing options, due to the following sector-specific factors: (i) the high initial investment cost; (ii) the banks' apprehension to develop new or unproven business/products lines, linked to the lack of relevant expertise to analyze and structure energy projects with weak credit and/or unfamiliar risk profiles of potential clients (e.g., energy users or generators) and; (iii) the lack of regulatory incentives. All these factors have resulted in the lack of adequate financial instruments to support renewable energy projects, which translates into relatively high transaction costs and high interest rates or excessive requests for collateral.

47. Banks assess the creditworthiness of both the technological partner and the end-consumer when analyzing the risk involved in these project finance operations. 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.