Second Amendment to the Mexico Private Sector Energy Efficiency Program

Submitted to the CTF Trust-Fund Committee
by the Inter-American Development Bank

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INTRODUCTION

1. The Mexico Private Sector Energy Efficiency Program ("Mexico CTF-IDB Group Energy Efficiency Program, Part I"), submitted by the Inter-American Development Bank (IDB) was approved by the Clean Technology Fund (CTF) Trust-Fund Committee (TFC) in May 2011.

2. The Program is a comprehensive initiative to help develop a market for private-sector financing of energy efficiency (EE) in Mexico funded by the CTF and other sources, such as IDB's own resources, and local financial intermediaries. This objective will be accomplished by supporting local financial intermediaries, technical intermediaries, and end-users and addressing the main barriers (i.e., behavioral, financial, technical) to implementing EE projects for small and medium-sized enterprises (SMEs) on a programmatic basis. More specifically, the interrelated barriers for increasing EE investments and activities include: (i) the absence of activities specifically targeted towards supporting EE efforts, and in particular the lack of a services market to support companies interested in using energy more efficiently, such as energy service companies (ESCOs); (ii) lack of information on improved technologies; (iii) lack of awareness among private enterprises as to the economic benefits of EE/; and (iv) absence of financial intermediaries (FIs) that act as promoters of investments in EE.

3. The Program included USD 22 million of reimbursable resources for the envelope's projects, USD 1.415 million in non-reimbursable resources for the knowledge management and technical cooperation components, and USD 0.985 million in non-reimbursable resources for other purposes (preparation of the Ecocasa program, and implementation and supervision costs for the Program.)

4. A first amendment, approved by the TFC in September 2013, changes some of the original terms of the program, expanding the scope of financial intermediation agents and mechanisms that the CTF could support.[1] In July 2014 the first subproject under the Program—Green Bond Securitization—was approved by IDB's Board.

5. The legal and financial structuring for the project execution is moving forward, with the financial closing with the private sector clients expected in the next few months. However, because of the complexity and innovative structure, some of the terms of the program need to be modified for the Green Bond to achieve the credit rating required to attract institutional investors.

6. This document explains the required amendments to the Program in order to accommodate the modifications to the Green Bond project. A summary of changes is included at the end.

GREEN BOND SECURITIZATION

7. The Mexican Green Securitization project entails financing of up to USD 150 million to promote sustainable energy (SE) investments in SMEs in Mexico developed by ESCOs. This includes resources from the CTF, the IDB, and potentially the International Finance Corporation (IFC) and other sources. The objective of the Green Bond is to increase access to finance and build capacity and awareness for related investments. The Green Bond will provide direct long-term financing to a portfolio of sub-projects investing in sustainable energy (SE) initiatives. CTF resources will be used, among other possibilities, to provide credit enhancement to such portfolio of projects, through the use of a Partial Credit Guarantee (PCG) in favor of (i) lenders to the warehousing facility, while the portfolio is developed to reach the

[1] This first amendment also moved USD 2 million out of this Program and into a new stand-alone project. It therefore reduced the amount of the Program from 24.4 M to 22.4.

critical mass needed for bond issuance; and (ii) bond investors. The Green Bond program is expected to be executed by 3 ESCOs in Mexico that will originate eligible projects for their subsequent securitization.

8. The objective is to issue a Green Bond with the maximum credit rating, and for that, the transaction structure requires different levels of credit enhancements to cover for construction, performance, and credit risk of the portfolio of projects during their financing through the warehousing line, first, and the life of the Green Bond, later. During the warehousing phase, IDB, as lender to the vehicle, will be taking on the construction risk; a CTF guarantee will be needed, however, to mitigate this and other risks at this stage. During the securitization phase the Green Bond will be subject of performance and credit risk. IDB's guarantees by charter can only cover credit risk. Credit rating agencies involved in the project have recently indicated that lack of guarantee coverage for performance risk would not allow to adequately credit enhance the Green Bond issuance to make it acceptable for institutional investors, therefore hindering demand for it.

SUMMARY OF CHANGES

9. Given the needs of the project as exposed above, the IDB proposes the following changes to the Mexico Private Sector Energy Efficiency Program:

a) **CTF guarantee coverage at warehousing phase.** In this phase, the CTF resources will need to be structured as a partial guarantee, with IDB and other lenders to the warehousing facility as beneficiaries, and to effectively share and mitigate construction, performance, and credit risk.

b) **CTF guarantee coverage to bond issuance.** In this phase, the CTF resources will also be structured as a partial guarantee, covering both performance and credit risks. While the IDB financing support at this stage will also be structured as a guarantee (partial credit guarantee), the scope of risks covered will be more limited than for CTF resources, as it cannot cover performance risk. IDB and CTF resources will therefore not rank pari passu, as envisioned in the original program terms.

   NOTE: In both cases (coverage during warehousing and bond phases), the CTF guarantee will be covering second losses. Floor price levels, tenor and other financial parameters (except for seniority considerations, as explained above) will be similar to those specified for the risk sharing guarantee facility option of the original proposal. As originally noted, the principle of minimal concessionality will always be applied to avoid unnecessary levels of subsidies.

c) **Technical cooperation activities.** Based on the needs of the Green Bond financial structure, some changes in the originally specified activities of the knowledge management and technical cooperation program will be required, to include some new activities critical for the implementation of the Green Bond program. Such new activities include support for green bond certifications, and third party project engineering and construction supervision of the energy efficiency projects. The total combined budget for the knowledge management and technical assistance components will, however, not change.