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GLOBAL ECONOMICS

LATAM INSIGHTS

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Challenges and Opportunities in Mexico's Power Sector

OVERVIEW

- **Mexico's manufacturing bottlenecks are among the issues holding back investment in the country.**
- **According to the IMF's Article IV consultation last November, close to 20% of firms' sales are absorbed by security costs (about 60% prevention and 40% incident costs). According to Banxico's report on regional economies, companies in the country cite security, power scarcity, and water scarcity as their major obstacles. On the power front, spare power generation capacity sits almost at a 40-year low.**
- **Despite the rising risks of power shortages, the government reversed a constitutional reform of the sector which opened avenues for private sector participation at the end of 2024.**
- **Following a large spike in the 2024 fiscal deficit, the government's financial fire power has become limited, which suggests private participation in the sector will be necessary. At this stage it appears that a combination of structures, including build-operate-transfer PPPS—similar to the old PIDIREGAS used by Mexico in the late 1990s to early 2000s—will be in the cards.**
- **PPPs, alongside self-generation at industrial parks, could be among the early bright spots for investment in Mexico (although PPPs will take time to get rolling).**

MEXICO ONLY PARTIALLY TAPPED INTO THE NEARSHORING STORY, IN PART DUE TO POWER SCARCITY

Mexico's opportunities in the global economy's regionalization are no secret. The country sits across the border from the US$29 trillion U.S. economy, which is embroiled in an escalating trade war with China. In that environment, Mexico can chip away at the Asian giant's share of U.S. manufactured goods demands. However, to fully reap the benefits of this opportunity, Mexico must be able to tackle ever growing input constraints and bottlenecks. We believe the four major bottlenecks or challenges for Mexico to accelerate its growth and investment are:

- **Security:** according to the **IMF's last Article Consultation on Mexico**, close to 20% of the sales of companies in Mexico are "eaten up" by security costs. The country's imperfect judicial system also plays a role on the relatively high cost of capital.
- **Power:** spare power generation capacity in Mexico currently sits near a 40-year low level, with about 55% of the country's power needed to operate the manufacturing sector.
- **Water:** according to the national water regulator (CONAGUA), **about a third to a half of the country currently faces** water scarcity risk, but more favourable weather conditions have helped alleviate the problem, which was materially worse last year.
- **Human capital:** Although Mexico produces world-class engineers, and many of them (**8th most globally**), the country scores poorly in PISA tables, and human capital levels are quite uneven. With tight labour markets, skilled labour in Mexico is scarce.

Of those bottlenecks, we would argue that the one most likely to get near-term relief is power. Security and education are solved with multi-year/decade institution building. Water has now partly been solved with benign weather, while the government has signaled some plans to invest in the sector. The power sector struggled for the past few years due to huge uncertainty over its legal environment, but is getting increased clarity, and there are signs that some openings for private sector roles are coming (more on this later and the accompanying paper from our equity research team).

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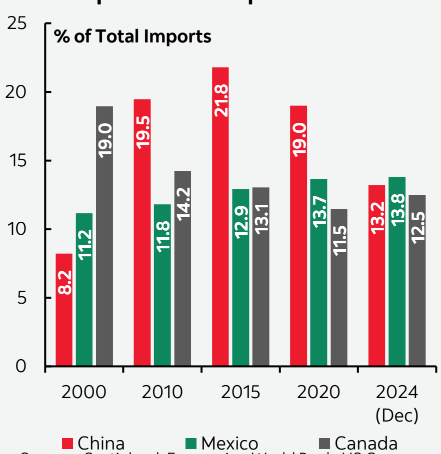
Chart 1

U.S. Imports from Top Trade Partners



Sources: Scotiabank Economics, World Bank, US Census Bureau.

These bottlenecks have been a crucial challenge for reaping the benefits of the "nearshoring opportunity" and are among the major reasons why more of the opportunity has not materialized. Back in 2000, China represented 4% of the global GDP, but its entry into the WTO at that time triggered a "growth miracle" that saw it reach a peak of 18% of the global GDP around 10 years ago. During that time, China also went from accounting for 8% of U.S. imports, to a peak of 22% in 2015. The rise of Trump in the U.S. primaries and subsequent first presidency triggered a reversal of this U.S.-China integration, driving a decline in the Asian giant's share of U.S. imports, which has nearly halved in the past decade. Interestingly, China still accounts for around 17% of global GDP, despite its disintegration from the U.S. economy. Mexico's share of U.S. imports has remained mostly flat, despite China losing about 40% of its pre-Trump 1.0 share in U.S. imports (charts 1 and 2).

CHALLENGES AND OPPORTUNITIES IN POWER FOR THE NEW GOVERNMENT

Mexico faces important challenges in energy security, with the country's power generation having the lowest spare capacity we have seen in close to four decades. This lag in power generation investment is largely attributed to the ambiguity of the country's legal framework, and uncertainty over rules of the game following the unsuccessful reversal of the 2013 Constitutional Reforms. In 2013, the Mexican government approved an ambitious reform that opened the energy sector to private investment, setting up autonomous regulators. In 2018, when Lopez Obrador took over, he sought to reverse the constitutional changes but failed to secure a constitutional majority for the reversal, hence only changing the corresponding laws, but failed to amend the constitution, which in turn led to contradictions and ambiguities on the sector's legal framework (charts 3 and 4).

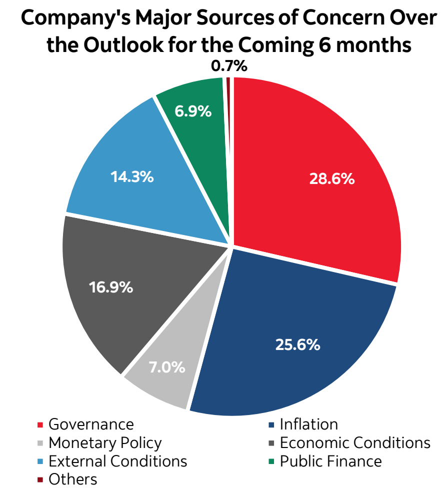
Following last summer's elections, and President Sheinbaum achieving the constitutional majorities to formally reverse the 2013 reforms, there will be more clarity on the legal framework—and some challenges. Although reversing the reform means the country now has less flexibility for allowing private sector participation in the power sector (at this stage, it appears that private participation will be limited to Public Private Partnerships and self-generation), having clarity on the framework will be an upgrade over the "limbo" of previous years. It's worth bearing in mind that before the 2013 reform, private participation increased from near 0% in generation, to over 30% under the PIDIREGAS framework (build-operate-transfer PPPs). PPPs have been successful in Mexico's power sector in the past, even if they have tended to be a more expensive solution.

Although the details of the new administration's plans are still in the process of being developed/published, it appears likely that available options will include PPPs (we are assuming build-operate-transfer schemes will be prevalent). On this front, it's noteworthy that according to the IADB/IEU Infrascope, Mexico has increasingly lagged countries in the region for its attractiveness, and changes to the country's judicial framework resulting from last year's judicial reform will likely add to the uncertainty, at least until the reform is fully deployed and its impact evaluated.

RISKS AND OPPORTUNITIES FOR A RELAUNCH OF PPPS

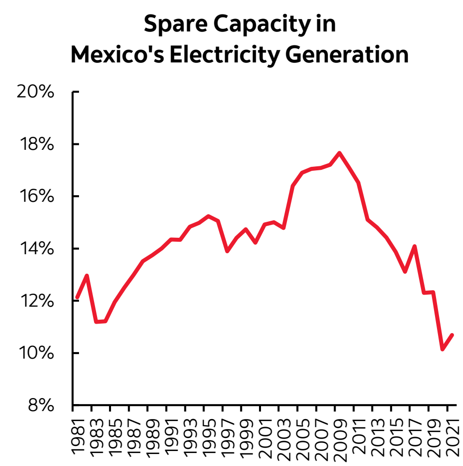
Although Mexico's fiscal position remains relatively robust, the 3-percentage point of GDP deficit blowout we saw in 2024 and the negative outlook to the country's credit ratings from Fitch both signal that fiscal consolidation will be necessary going forward. This in turn puts the government in a somewhat challenging position regarding the power sector, given they have imposed a constitutional reform, which means the government must control 54% of the country's power sector (some details on the measurement of this constraint remain unclear), and they now have fewer fiscal resources available. This in turn suggests attracting private capital will be important.

Chart 2



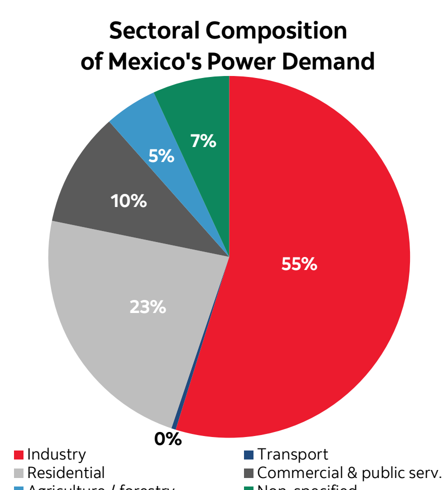
Sources: Scotiabank Economics, Banxico.

Chart 3



Difference between generation capacity - consumption, expressed as % of generation capacity.
Source: Scotiabank Economics.

Chart 4



Sources: Scotiabank Economics, EIA.

A combination of factors, including the risks outlined above, has led to a deterioration in Mexico's environment for PPPs, according to the EIU/IDB Infrascope ranking, and has left Mexico with a worst overall score than other key economies in the LATAM region (Chile, Peru, Colombia, Brazil, etc.). Mexico is also lagging key economies in Asia in its **latest global ranking**, and is 8th within LATAM in its **latest regional one**. The good news is loss of attractiveness can be compensated by paying a premium, and at the right price we assume global players will look at opportunities in Mexico (charts 5 and 6).

Attracting private capital into Mexico currently faces some uncertainties, including:

- How the rollout of the country's judicial reform (which among several changes includes making judges elected by popular vote) will affect contract enforcement. According to the **EIU/IDB Infrascope**, Mexico ranks 56th among global EMs in the quality of business and investment climate (1 being best), and that was before the rollout of the judicial reform, which is expected to erode it further. This can be somewhat compensated by offering direct recourse to international arbitration (we assume CPTPP will be relied on, as USMCA has an expiry date in 2036, which would likely fall in the short end of a PPPs lifecycle).
- In addition, with fairly widespread influence of Mexican drug cartels along the country's territory, and the U.S. government designating them as Foreign Terrorist Organizations (FTOs), there is an **ongoing debate** on **how this could** affect the **investment climate**.
- On the positive side, there are three important sources of opportunity for a take-off of power sector PPPs in Mexico.

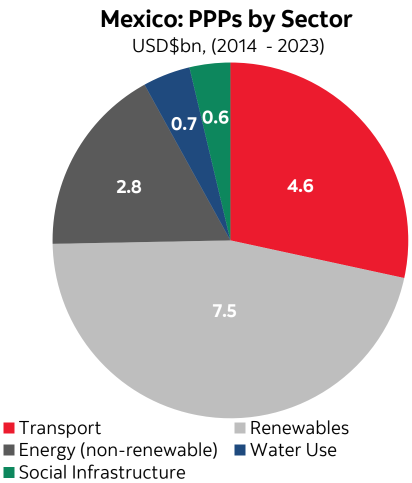
  1. Financing: Mexico scores well in the Infrascope rankings, and the rapid growth in local pension funds' AUMs will help further; contributions into workers' individual accounts will rise from 6.25% to 15% of workers' salaries, estimated to add about US$200 billion to local pension funds AUMs by 2030. Local pension funds have different structures through which they could invest in power assets.

  2. Desperate need for power, alongside fiscal constraints, will likely mean flexibility by the government on PPP conditions. The government needs to cut spending or increase revenues by around 3 percentage points of GDP. This means it will likely need to be flexible in order to successfully attract private players. We expect this could mean contracts that include explicit recourse to international arbitration, and possibly also guarantees from the CFE (Federal Electricity Commission) or the government.

  3. Self-generation/self-supply frameworks have been revealed, and we anticipate some players in the industrial parks sector will be interested in getting involved in these mechanisms.

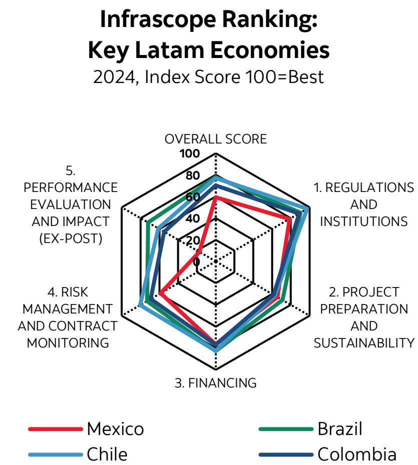
The bottom line is that the government does not need to reinvent the wheel. An undated framework similar to the PIDIREGAS, which worked well in the early 2000s, should be enough to attract increased private investment into the sector (chart 7).

Chart 5



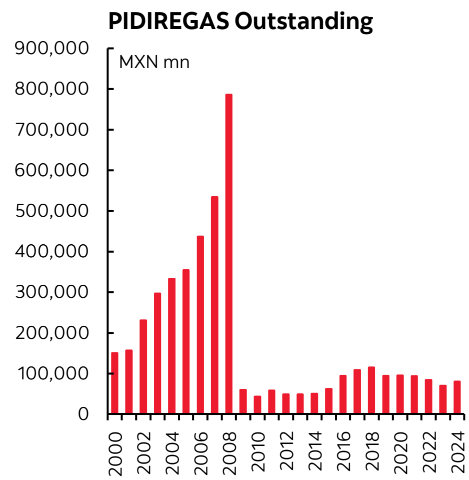
Sources: Scotiabank Economics, EIU / IDB Infrascope.

Chart 6



Sources: Scotiabank Economics, EIU/IDB Infrascope.

Chart 7



Sources: Scotiabank Economics, Mexican FinMin.