

Energy, Natural Resources & Utilities

A legal guide

2000

**Published in
conjunction with:**

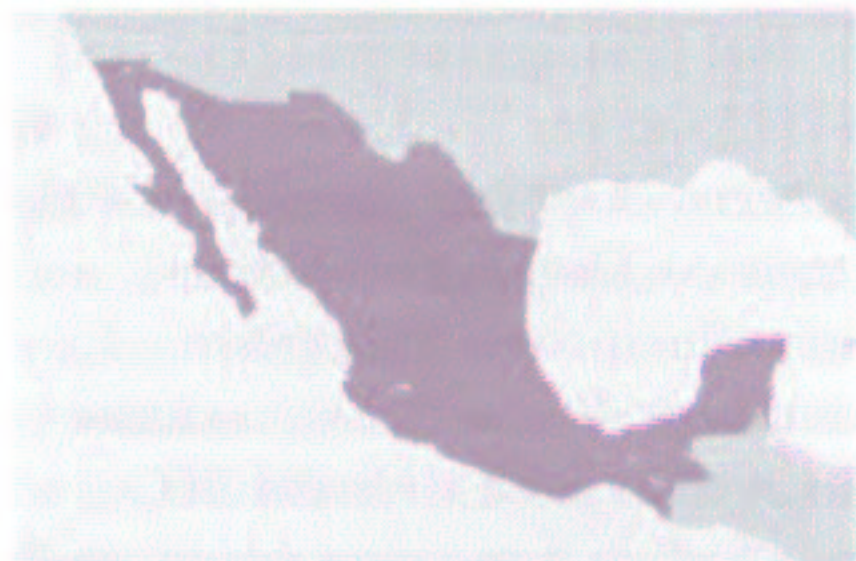
Andersen Legal
Bruckhaus Westrick Heller Löber
Gomez Acebo & Pombo
Nauta Dutilh
Noriega y Escobedo
Vinson & Elkins LLP
Waselius & Wist

IFLR

INTERNATIONAL FINANCIAL LAW REVIEW

Mexico

THE OPENING OF THE MEXICAN ELECTRICITY INDUSTRY



**By Miguel Angel
Quintana of Noriega y
Escobedo**

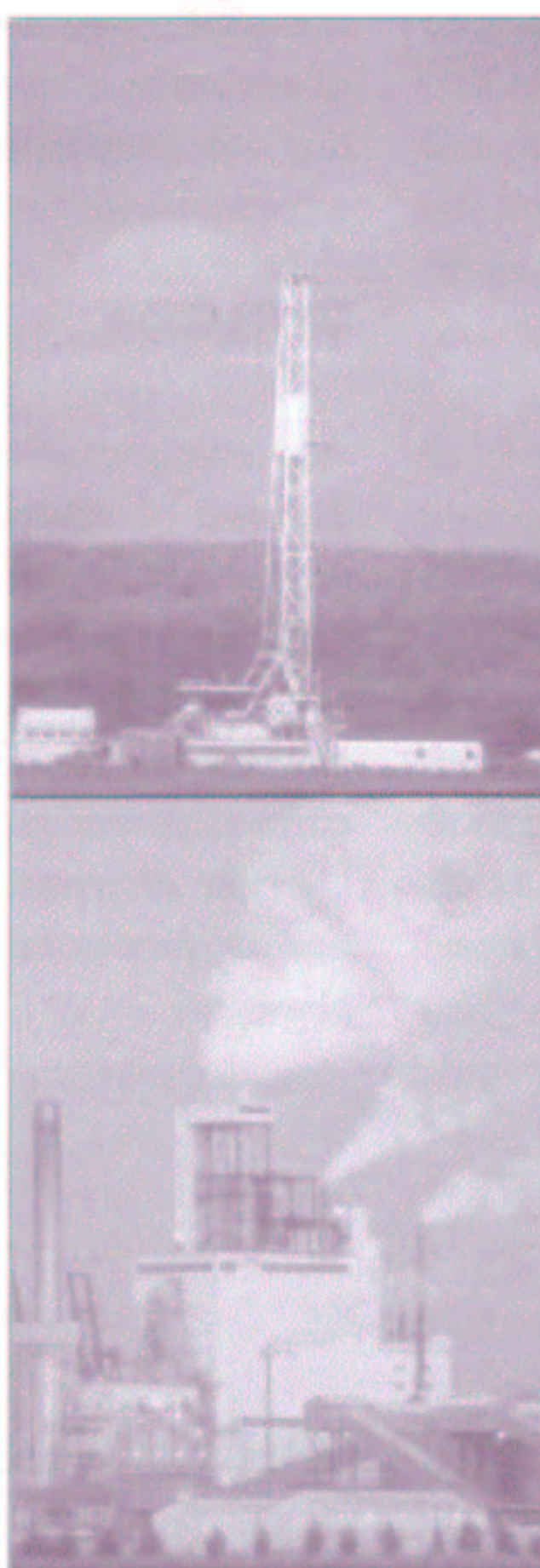
More than one year has passed since President Zedillo submitted a bill before congress to amend the constitution and open the electricity industry to private investment.

Constitutional reforms often take several months to be approved, but this one has taken even longer than expected.

The opening of the electricity industry has faced different challenges. The collapse of the peso and the economic crisis that followed dictated that the government had to prioritize the reorganization of the economy, which required the adoption of controversial and sometimes highly unpopular measures. A fractious Congress in which the PRI party has not been able to gain the required majority for the bill to pass has produced a political stalemate. It is clear that the opening of electricity industry will have to wait until after the Presidential and Congressional elections in July 2000.

WHERE DOES THE ELECTRICITY INDUSTRY COME FROM?

Private investment is not new in the Mexican electricity industry. Actually it is the oldest source of power in the country. Mexican electricity generation started at the end of the last century and was



carried out by private entities in the mining and textile industries.

In the twenties the government started to play a role in the industry by creating the National Power Commission and by issuing regulatory legislation. To make available more power to the country the federal government created in 1937 the utility entity Comisión Federal de Electricidad (CFE). During the forties and fifties CFE increased its role in the still youthful Mexican power industry.

In 1960 the federal government nationalized the electricity industry. Accordingly, the Constitution was amended in order to establish the basic rule which still remains in force today and that sets forth the nation's exclusive right to generate, conduct, transform, distribute and supply electric power which is to be used for public service (notwithstanding the nationalization of the industry, private entities continued to generate

AUTHOR

Miguel Angel Quintana

Miguel Angel Quintana was born in Mexico City in 1962 and began his practice in 1981 in the firm of Noriega y Escobedo, where he became a partner in 1993. Besides energy, his practice includes corporate, foreign investments and trusts; in the energy field, Mr Quintana has provided local counsel to his clients in private and public projects, including Rosarito (TNPP), Merida III, Hermosillo, Rio Bravo, Tuxpan II, Monterrey III, Altamira II, Campeche, Naco Nogales, Rosarito 10 and 11, Celanese, Kosa, Pegi, Ispat, etc. Mr Quintana is member of the Mexican Bar, of the Cogeneration Sub Commission (CONAE), and vice-president of the Electric Energy Mexican Association.

power for self-supply purposes).

In 1992 and 1993 the electricity industry regulatory framework was amended to attract private investment. The amendments basically defined the activities not considered as a public service and which could be carried out by private entities.

They are, power generation through any of the following schemes:

- self supply; cogeneration either for self-consumption or to export power;
- small production for self-consumption, to sell the power to CFE or to export it;
- independent power producer, either to sell power to CFE or to export it;
- generation for interruptions in the service; and
- importation of power for self-consumption.

WHERE DOES THE ELECTRICITY INDUSTRY STAND TODAY?

The electricity public service is carried out by the CFE and Luz y Fuerza del Centro (LFC); CFE is in charge of the public service in most of the country, except Mexico City and part of the states of Mexico, Morelos, Hidalgo and Puebla which are served by LFC.

The national installed capacity includes 168 power centrals, with a total of 570 generation units that produce 36.1GW. The combined installed capacity of CFE and LFC represents 92% of the national total, the remaining 8% is in the hands of private producers through self-supply and cogeneration projects, and by Pemex. The power is produced basically by conventional steam units, combined cycle and gas fire turbines (53%); other generation facilities include hydroelectric (28%), coal fired (7%); dual (6%); geothermic (2%), and nuclear (4%).

Transmission lines cover 74,000km (basically of 400, 230 and 115kV high tension). Distribution systems (medium and low tension lines) cover 592,000km.

According to government sources the approximate number of consumers served by both CFE and LFC amounts to 22 million, which in turn represents an estimated 95% of the national population. So, in 40 years, despite inefficiencies, Mexico's rough terrain country was electrified.

Although the amendments of the early ninties to the electric power framework were positive movements — by the end of last century the government realized what can be summarized in two facts:

- the 1992 and 1993 legislative amendments did not bring in all the private investment that was originally expected; and
- due to the current and future demands of power and to further support the growth of the economy, the government may not be able to expend the enormous amounts of investment required to meet such goals without affecting other social development and infrastructure projects where private investment may be difficult to attract.

OUTLOOK

According to government estimates, the increase in the demand of electric power will require \$25 billion in the next five years to build an additional power generation capacity of at least 13GW and to modernize the transmission and distribution networks. The increase in the generation capacity represents more than one-third of current power generation capacity.

The government has expressed its intention to carry out the process to amend the electricity sector in three phases:





- first phase — CFE and the LFC transformed in different entities in charge of generation, distribution, transmission, nuclear power; operation of the national net and the market (dispatch) by the National Electric System Operation Centre (COSEN); regulatory framework will be issued and market will be designed;
- second phase — new electric power market start operations; generation and commercialization of power performed by private and governmental entities; concessions granted to transmission companies; and
- third phase — governmental entities in charge of generation, transmission, and distribution will be progressively sold to third parties.

Important legislative changes will have to be made to create the new scheme: besides the constitutional initiative, other legislative actions including the enactment of laws, regulations, decrees and official norms, and the amendment of current laws such as the Foreign Investment Law will also have to be amended.

In light of these potential changes several industry players including developers, traders, equipment manufacturers, construction companies, engineering firms, advisers and off-takers have moved forward to propose fundamental aspects for the development of what should be considered as a market with international competitive standards. To summarize those fundamental aspects:

- a quality, reliable and economical electricity supply service must be guaranteed for all Mexicans;
- private entities must have guaranteed access to the sector; the state remaining in charge of its rectorship; and
- legal framework to be amended to provide legal certainty and to boost efficient generation schemes such as cogeneration and self-supply; legal restrictions that affect the sector such as the 20MW limit to sell capacity derived from surplus power to CFE, and the new 5% annual limit for tax depreciation of utility assets have to be reviewed and amended.
- the sector must be reorganized by the segmentation of the generation, dispatch, trading, transmission and distribution activities to achieve a complete market, subject to the forces of supply and demand, and supervised and regulated by the state.
- generation carried out by the state and private entities (except for nuclear generation which will remain an exclusive activity of the state), with controls to avoid

monopoly activities;

- regulated tariffs, interconnection and free access to transmission will be guaranteed for all, including cogenerators and self-suppliers;
- transmission controlled by the state, if private investment is allowed, a participant will not have a portion of the market that affects the competitiveness of the industry;
- distribution made in determined geographical areas (private investment permitted);
- traders will be able to purchase and sale power in the markets to qualified users (private investment permitted);
- dispatch made by an entity conformed by the industry participants (the government-owned and private participants), authorized and supervised by the Energy Regulatory Commission (CRE).
- Electricity market composed by traders, distributors and qualified users who may carry out their transactions inside or outside the central electric market;
- market operated by one or more market operators who will handle the purchase and sale offers system;
- operators' main functions are (i) to receive and process sale and purchase offers of power and to assign such offers; (ii) to communicate the offers to all interested parties; and (iii) to receive and deliver payments derived from the power transactions;
- operators will have as shareholders the producers, traders, distributors and big consumers who will be entitled to acquire a participation in the capital stock of the operator when their concession is granted
- operators will be supervised by the CRE; representatives of the government appointed as directors;
- as thermoelectric generation represents more than 50% of the installed capacity and hydroelectric generation represents almost 30%, fuel supply will have to be reliable and competitive and concessions will be granted for hydroelectric projects to private entities.

CONCLUSIONS

The opening of the Mexican electricity industry represents a great challenge for the Mexican government and for private investment as well.

IPP projects (either under construction, bid process or to be called for bids) still represent the main alter- ➤

native for power industry growth, but may not be enough to cope with future demands.

In an everyday more democratic Mexico, the executive and legislative branches of the Mexican government face a vast legislative challenge. If the situation of the electricity markets of the world is revised it seems that the way to go should be that of open markets and globalization. Experiences of other countries in the opening of its electricity industries are quite helpful but simply to copy them may be a mistake. Although Mexico may benefit from such experiences, the particularities and characteristics of the Mexican electricity industry and of the country's economy will have to be adequately combined with experiences from other markets to produce the most favourable option for the development of the sector.

For the Executive the challenge will be to convince a new congress, and certain sectors of the society that:

- the demographic and industrial growth of Mexico require the development of a modern and bigger power industry, and that to achieve such goals, consid-

erable resources have to be invested which the government just does not have or which are needed to direct to other key social fronts such as health and education;

- that the openness of the sector does not mean the antinationalistic idea of selling all of the country's utility assets to private investors and the firing of all utility employees, as may be perceived by certain sectors of society; and

- last but not least, that the new scheme will positively affect the pockets of ordinary citizens who will benefit with more competitive prices and a better service

For private investment, either national or foreign, the opening of the Mexican electricity industry represents a big challenge, but also a magnificent opportunity. With adequate legislation that provides equal conditions and legal certainty to its participants, the electricity industry will become one of the most attractive business opportunities in Mexico and in the developing world.

NORIEGA Y ESCOBEDO

ABOGADOS ATTORNEYS AT LAW ADVOCATS

Established in 1934

General and International Practice, Administrative, Antitrust and Trade Regulation, Banking and Finance, Litigation, Communications, Corporate, Energy, Environmental, Financial Institutions and Transactions, Foreign Investments, Franchise, Immigration, Intellectual Property, Insurance, International Law, Litigation, Maritime, Mergers and Acquisitions, Mining, NAFTA, Oil and Gas, Privatizations, Railroads, Real Estate, Securities, Taxation, Technology Licensing, Telecommunications, and Trusts

Edificio Noriega y Escobedo
Sierra Mojada 626
Col. Lomas Barrilaco
11010 Mexico, D.F.

Telephone: + (52) 5327 1111
Telefax: + (52) 5327 1100 / 5327 1112 / 5327 1127
info@noriegayescobedo.com.mx
<http://www.noriegayescobedo.com.mx/>

Afiliación Internacional
Cassels Pouliot Douglas Noriega
Toronto - Montreal - Vancouver - Mexico