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# Restructuring Mexico's Electric Power Sector: Legal, Regulatory and Market Challenges

*George Baker\**

## I. Introduction.

- A. MEXICO'S INVESTMENT-GRADE STATUS.
- B. GOVERNMENT PROCUREMENT ACT OF 1999.

## II. Process of Market Opening in the Energy Section.

- A. HISTORY, 1992-1999: FROM LIGHTBULB TO WELLHEAD.
- B. OBSTACLES AND SETBACKS.
  - 1. *Petrochemicals.*
  - 2. *Natural Gas Transportation.*
  - 3. *Electric Power Generation and Distribution.*

## III. Issues Ahead.

- A. CREATING NEW ENERGY PRICE HUBS WITHIN MEXICO.
- B. ACHIEVING DEREGULATED ELECTRICITY TARIFFS.
- C. POLICY-IMPLEMENTATION PROBLEMS IN THE ENERGY SECTOR.

## IV. Conclusion.

## I. Introduction.

Broadly speaking, Mexico is undergoing a transition from a centralized, command-type economy to an open, market-oriented economy. Currently, however, Mexico is much closer to a closed, centralized economy than an open, market economy.

In the energy sector there are a number of obstacles and challenges that to date have impeded a smooth transition to a market-based economy. Although some of these obstacles exist outside the energy sector, they have a potential for jeopardizing the investment rating of Mexico's power sector.

Before turning to issues specific to the energy sector and electric power in particular, broader issues should be considered.

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#### A. MEXICO'S INVESTMENT-GRADE STATUS.

One very general issue is Mexico's possible ranking as an investment-grade market, a ranking that some observers expect to be given in the year 2000. The lack of an investment-grade standing has had a negative effect on the financing of Independent Power Projects (IPPs). Of eleven awards that have been made by Mexico's Energy Regulatory Commission (CRE), only two have reached financial closure.

The first reason is Mexico's legal system. As it is based on Napoleonic code, the legal system is not required to follow the principle of judicial precedent, except under narrow conditions. Therefore, the courts' behavior is unpredictable because the legal framework and judicial institutions that currently exist have not been tested in cases in which international companies in the energy sector seek relief from actions or omissions of the state energy utilities. For example, suppose that an IPP supplying power to the Federal Electricity Commission (CFE), the state-owned electric utility, were forced to shut down or scale back its operating schedule due to a supply shortage of gas, inadequate gas compression, or quality. What legal recourse or relief would be available to the IPP? At this point, it is unclear what legal recourse the international lender might have if the IPP operator was unable to honor payment obligations because of poor gas quality or compression.

A second element affecting Mexico's status as an investment-grade market is the lack of Freedom of Information legislation. While the stated purpose of government policy guidelines and laws is to encourage private investment, government enterprises are not obliged to publish data on markets or existing infrastructure that would permit companies to evaluate investment opportunities. For several years the Energy Ministry has published annual ten-year forecasts of the electric and natural gas markets. Such forecasts of demand, however, hardly give investors sufficient information to reach conclusions about investing millions of dollars in hard and soft assets. Beyond these annual forecasts, the public reporting requirements of the energy sector appear to be completely unregulated; information is reported purely on a discretionary basis.

A third element is the dichotomy in Mexico between what might be called energy commerce and energy populism. State energy enterprises in Mexico, for being government-owned, have two flags: (1) commercial organizations having revenues, assets, and liabilities, and (2) national security symbols and sovereign immunity. With the second flag in hand, managers of state energy utilities are able to gain a commercial advantage. In 1997-98, Pemex, the state-owned oil company, argued to the Mexican government that Mexico's natural gas import duty should not be eliminated because it might require Mexico to shut in some oil and gas fields, a measure that would jeopardize Mexico's energy self-sufficiency. Against such a position, arguments in favor of market efficiencies and competitive pricing can have little weight.

A fourth element is the creditworthiness of the CFE. In the electric power sector, some question the ability of the CFE to honor Power Purchase Agreements (PPAs), given that the power utility has no income in foreign exchange and its tariffs for all of its customers, residential, commercial, and industrial, are decided upon by outside agencies and ministries. Many bankers are concerned that any future restructuring of the CFE could put the contractual status of PPAs in jeopardy.

## B. GOVERNMENT PROCUREMENT ACT OF 1999.

A new storm cloud on the horizon having a legal and NAFTA-related meaning is the broad subject of government procurement.

On November 5, 1998, the government quietly submitted bills to Congress that would change the provisions and principles of the existing Government Procurement and Public Work Act of 1993. The government's proposal, contained in bills currently before the Chamber of Deputies, is to separate the existing legislation into two laws: one dealing with procurement, and one dealing with public works. One of the formal objectives of both bills is to subject commercial, state-owned enterprises to the same procurement and contracting rules as the state ministries, which, by their nature, are not-for-profit.<sup>1</sup>

The Government Procurement Act of 1999 proposes to subject all purchasing activity by government ministries and government-owned enterprises (including the energy utilities) to a single set of rules. While the notion of a single set of rules for purchasing would seem to be pro-market (or, at worst, neutral), closer inspection shows that the proposed law would have a series of direct and indirect negative effects on commerce, as well as the expansion and technological advancement of capital-goods intensive industries such as those of the energy sector.

The new law would require that all commercial offers for goods and services under public tenders whose final destination is Mexico should:

1. be quoted for delivery in Mexico with duties either paid or unpaid,
2. be payable in Mexican pesos, using the exchange rate on the date of payment, and
3. have contracts that are enforceable only under Mexican law.

The proposed law contains a provision that appears to be against the spirit of NAFTA. Article 14 requires that a ten percent price advantage be given to a Mexican company whose offer contains at least fifty percent of Mexican national content. This means that an international company offering a tool that is forty-nine percent Mexican national content at a price of \$91 will be outbid by a Mexican company offering the same tool for \$100 and fifty percent national content.

Under article 16 of the proposed framework, international original equipment manufacturers (OEMs) and distributors would face the additional market-entry hurdle of having to negotiate and sign contracts in Mexico, thereby incurring local attorney and representation fees and travel expenses.

The spirit of the proposed law appears to be anti-market in that it forces the purchasing policies of the government's commercial enterprises, such as Pemex and CFE, to standards and rules applicable to government bureaucracies who, by definition, have no commercial goals whatsoever.

If the bill becomes law, it will require that international OEMs and distributors expand their business services to include freight forwarding, customs administration, and Mexican tax accounting. For OEMs and distributors accustomed to delivering their goods to U.S. and other international delivery points for Mexican state-owned, commercial enterprises, the new rules will force them to add not only the estimated costs of freight handling in Mexico but also an extra margin of safety to cover country risk and exchange-rate exposure. In short, the same tool that the international company had offered for \$91 FOB Houston might now be quoted as \$125 Delivery Duty Paid (DDP).

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1. The Web site of the Mexican Congress is <<http://gaceta.cddhcu.gob.mx>>. The site's search engine (*Ley de Adquisiciones*) leads the reader to the text of the bill.

Some OEMs and distributors will choose not to participate in government public tenders at all, given the added uncertainty associated with the complexity of the rules and procedures and a new set of hard and soft expenses associated with local legal and market representation.

The new framework will, if implemented, have a paradoxical effect on commercial relations between the United States and Mexico. On the one hand, it will promote the emergence of a new set of entrepreneurs whose business purpose would be to compete in national and international public tenders and whose competitive advantage would be strengthened by the ten percent margin given to Mexican companies. But, both Mexican government enterprises and ministries, in awarding contracts to Mexican companies, forego access to Exim-bank type financing, which is only available where the buyer is a government or its agent.

The net effect is that once the new procurement rules are applied in Mexico, refined products and electricity will cost more, and the commercial market from the exporter's perspective will be seen as having greater risk. As was said earlier, this topic is not one that is specific to the energy sector; it is one that both trade attorneys and NAFTA specialists should examine closely. We may now consider topics directly related to the energy sector.

## II. Process of Market Opening in the Energy Sector.

### A. HISTORY, 1992-1999: FROM LIGHTBULB TO WELLHEAD.

The history of the market opening in Mexico's energy sector is unlike most other countries. In other countries, a market opening takes place in the upstream, at the wellhead, and later spreads to the downstream and midstream. In Mexico, the initial market opening took place "at the lightbulb," in electric power generation, and it now seems to be working itself backward toward the wellhead.

In December of 1992, the administration of Carlos Salinas authorized private electric power generation. When bankers balked and complained that the new IPP facilities would have only one source of fuel supply, the state oil utility, thereby exposing the project to excessive risk, the Salinas administration began work on a plan to open natural gas transportation to private investment. The first draft of this plan was leaked to the press in August of 1993.

In November of 1995, the administration of Ernesto Zedillo released a broad plan for the natural gas sector that authorized private investment in gas transportation, distribution, and storage. This multifaceted measure accomplished its goal of attracting private investment in retail gas distribution. The measure was also intended to permit and stimulate open access on Pemex's pipeline system, which, in four years, it has not yet accomplished. Finally, the measure was conceived to encourage private investment in natural gas storage, a function that, today, is performed only imperfectly by means of line-packing and indirectly by means of spot trading on the U.S. gas market. After four years, private investments in natural gas storage are still in an uncertain future.

In February of 1999, the Zedillo administration proposed a broad restructuring of the electric power sector. The measure was aimed at attracting private investment into generation and regional and local distribution. This measure has generated substantial

political and labor opposition, and it is unlikely that the initiative will become law during the Zedillo tenure in office, which ends November 30, 2000.

## B. OBSTACLES AND SETBACKS.

The process of opening to a market-oriented economy in Mexico has generated a counterforce of political and institutional opposition within the government itself, as well as within government agencies, labor unions, political parties, and civil society in general. Nowhere in the economy can this counterforce be more plainly seen than in the energy sector.

### 1. *Petrochemicals.*

In petrochemicals, the Administration's plan to privatize government-owned plants and complexes was overturned by the Oil Union and its political allies.

### 2. *Natural Gas Transportation.*

In natural gas transportation, the Administration's plan to stimulate a competitive environment in natural gas supply through the wide use of the Open Access option on Pemex's pipelines was defeated by a series of factors. The first was the government's mixed signal to Mexican heavy industry conveyed by the continued presence of the government's own import duty on natural gas (not eliminated until August of 1999), a duty that, in effect, made imported gas noncompetitive with Pemex's rolled-in regional prices. The second was the implementation of a system of netback pricing that ties Mexico's natural gas prices to fluctuations of gas prices in the Houston Ship Channel. Although this mechanism would seem to be pro-market, in three and a half years the system has demonstrated otherwise. The third was the aggressive marketing policies of Pemex Gas in markets (principally Monterrey) that it wished to control. The fourth and final was the willingness of the CRE to be influenced by Pemex and its clients in making regulatory decisions that weakened competitive conditions in natural gas markets.

### 3. *Electric Power Generation and Distribution.*

In electric power generation and distribution, the government has been set back because of a starting point for reform that was so murky that any proposal for restructuring allowed anyone to question the premises. The government said, in effect, that the state had to choose between investing some \$25 billion in Mexico's war on poverty and in private power generation. Critics, leaving aside the outcries of the energy populism in Mexico, asked why the Zedillo proposal was silent on key points including:

- (1) the role of renewable energy sources,
- (2) the role of demand-side management,
- (3) the potential for gains from increased conservation and energy efficiency,
- (4) the potential role for cogeneration,
- (5) alternative power tariff proposals for industrial and retail customers, and
- (6) alternative tax options for the government power utilities.

Responsible critics said that from a set of policy measures in these areas it would be possible to cover most, if not all, of the predicted capacity deficit in power generation. In short, the government either had not done its homework or it was choosing to ignore alternatives other than its favored solution.

### III. Issues Ahead.

#### A. CREATING NEW ENERGY PRICE HUBS WITHIN MEXICO.

The outlook for market development and investment opportunity in electric power depends primarily on the creation of natural gas price hubs within Mexico. For this to happen, the Houston Ship Channel must be replaced by price hubs for natural gas in major metropolitan areas such as Monterrey, Cd. Juárez, Chihuahua, Mexico City, and Guadalajara. For such price hubs to appear, the Open Access policy must not be a dead letter in the CRE's regulations.

#### B. ACHIEVING DEREGULATED ELECTRICITY TARIFFS.

One of the most frequently asked questions about the future of electric power tariffs in Mexico concerns the direction of electric power tariffs under a deregulated, competitive framework. Government analysts believe that electricity prices will fall, while industry analysts believe that prices will rise.

Generally omitted from the discussion of the tariff outlook is the effect that the combination of CRE netback pricing and regulated natural gas tariffs will have on electricity prices. Indirectly, and absent Open Access in natural gas transportation, future electric prices will be held hostage to a natural gas pricing regime that favors the status quo of Pemex having a de facto monopoly in natural gas transportation.

#### C. POLICY-IMPLEMENTATION PROBLEMS IN THE ENERGY SECTOR.

The Mexican government faces four major internal problems in the implementation of energy policy in Mexico:

- (1) The institutional opposition within the state energy enterprises themselves.
- (2) The opposition found across a spectrum of civil society in Mexico that is fueled not only by energy populism (largely self-serving in the case of the official energy unions), but also by a broad distrust of the privatization policy itself.
- (3) The lack of auditing institutions for the energy sector that have the staff, budgets, and authority to review management performance and industry unit costs. Without the credible results of such audits, the government's moral authority for policy innovation will continue to be questioned.<sup>2</sup>
- (4) The widespread perception that it is the state oil enterprise, not the Mexican government that establishes and implements energy policy in Mexico.<sup>3</sup>

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2. In the summer of 1999, the Government Comptroller's Office (SECODAM) carried out a series of audits on the details of several contractual matters dealing with platforms in the Gulf of Campeche. SECODAM went so far as to suspend several senior Pemex officials from their duties. There were two fatal problems with these audits: they dealt with trivial issues, and they ignored the day-to-day costs and performance standards on the platforms and in the fields. They examined a one-of-a-kind situation: contracts left to deal with conditions brought about by a hurricane. SECODAM not only discredited the concept of a Pemex audit, but also left all substantive matters untouched.
  3. On November 5, 1999, the day the market liberalization in natural gas was announced, there were sharp discrepancies in the perspectives set forth by the Energy Minister and the CRE (on the one side) and the Pemex spokesman (on the other side). The industry audience, consisting of Mexican and international senior managers, knew immediately that Pemex's views would prevail—a presentiment that future events would show to have been correct.
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#### **IV. Conclusion.**

Demand forecasts in the electric power sector do not thereby identify business opportunities. The indirect effects of netback pricing for natural gas, the lack of Open Access on Pemex's pipeline system, and the conspicuous absence of a single non-Pemex gas pipeline in markets controlled by Pemex together will sharply constrain the market opportunities in the electric power sector. Private investment in the electric power sector will be sharply affected by the government's ability to negotiate political solutions in civil society with the energy labor unions, opposition parties, and non-governmental organizations (NGOs). The neo-protectionist philosophy and provisions of the proposed framework for government procurement deserves scrutiny by NAFTA specialists and corporate legal advisors. The successful transition to a market-based economy awaits the resolution of these legal, institutional, and political issues.