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## Mexico Adopts Major Energy Reforms Restructuring its Electric Power Sector

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*Mexico has recently adopted amendments to the Mexican Constitution that will profoundly change all aspects of the electric power sector in Mexico. Among other things, those amendments (1) reduce the role of the State in the power sector, (2) foster private participation to provide capital, technology and expertise, (3) recast CFE, currently Mexico's national power company, as an autonomous "State Productive Enterprise," (4) establish an independent system operator, and (5) revise the regulatory framework, with a reorganized Energy Regulatory Commission as a key regulator. The terms of the implementing legislation for the constitutional amendments – yet to be presented to the Mexican Congress – will be critical in determining how the private sector will be able to participate in the reform of the power sector.*

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Mexico has adopted amendments to the Mexican Constitution, effective December 20, 2013, that will profoundly change all aspects of the electric power sector in Mexico. This set of amendments provides a framework to:

- Limit the role of the State in the power sector to planning and control of the national electrical system, and the public service of transmission and distribution of electricity;
- Foster private sector participation to provide capital, technology and expertise, including private sector involvement in the financing, operation and expansion of transmission and distribution infrastructure, as well as an unprecedented role for the private sector in the generation and marketing of electricity in Mexico;
- Recast the Federal Electricity Commission (*Comisión Federal de Electricidad* or "CFE") – currently Mexico's national power company – as a State Productive Enterprise with technical, management and budget autonomy, subject to limited controls by the State;

- Establish the National Center for Control of Energy (*Centro Nacional de Control de Energía* or “CNCE”) – now a unit of CFE – as a public body responsible for operating the national power system and the wholesale power market, and ensuring open and non-discriminatory access to the Mexican transmission grid and distribution systems;
- Revise the regulatory framework for the restructured national electrical system, including reorganization of the Energy Regulatory Commission (*Comisión Reguladora de Energía*, or “CRE”) to serve as a key regulator;
- Promote the protection and care of the environment through sustainability principles, the use of renewables and cleaner fuels, particularly natural gas, and implementation of measures to reduce polluting emissions from the electric power industry;
- Promote the participation of domestic and local supply chains through requirements for minimum percentages of national content, subject to compliance with the international treaties and commercial agreements to which Mexico is a party; and
- Ensure transparency and accountability in the power sector, including with respect to the contracts entered into with private parties.

The Constitutional amendments themselves lay out fundamental precepts, but those precepts will need to be implemented by means of legislation. In the Decree adopted by the Mexican Congress and signed by the President to amend the Mexican Constitution (hereinafter referred to as the “Energy Reform Decree”), there are a series of “Transitional Articles” that set forth the legislation that will be required to implement the Constitutional amendments, including in many cases the broad outlines of that legislation. The Constitutional amendments and the Transitional Articles together constitute the “Energy Reform,” although the detailed terms of the reform will not be known until the implementing legislation is adopted.

It is currently anticipated that the first and most substantial part of the proposed implementing legislation will be submitted to Congress in late February or in March. The administration of President Peña Nieto hopes to have this legislation approved and in place by the end of the legislative session in April 2014, consistent with the Energy Reform Decree requirement that several elements of the implementing legislation must be adopted within 120 days after the Energy Reform amendments to the Constitution became effective, i.e. by April 19, 2014. However, in light of the large number of constitutional reforms and secondary laws currently on the Congress’ agenda with respect to energy and other matters, it is not certain how much of the implementing legislation will actually be adopted by the end of the current legislative session.

As noted below, the Energy Reform Decree provides that certain additional implementing legislation and regulations, including the decree to create an independent system operator, will be adopted a year or more after the effective date of the Energy Reform Decree, i.e., a year or more after December 20, 2013.

Industry participants should monitor the various elements of the implementing legislation as they proceed through the Mexican Congress in order to evaluate the potential opportunities presented and to mobilize for pursuit of deals upon their adoption.

## The Objectives of the Energy Reform

According to the Mexican government, the Energy Reform is focused on achieving the following objectives:

- Allow the Nation exclusively to carry out planning and exercise control over the electrical system, for the benefit of a competitive system that reduces the price of electricity.
- Have a greater supply of energy at better prices.
- Attract investment to the Mexican energy sector to boost the country's development.
- Modernize and strengthen, not privatize, CFE as a productive state enterprise that will be 100 percent Mexican.
- Ensure international standards of efficiency, transparency and accountability.
- Promote development with social responsibility and protection of the environment.

## Diagnostics and the Mexican Government's Response

To understand why Mexico took the path it did in designing the Energy Reform, it is helpful to understand (1) the issues that the Mexican electric power sector has been facing, and (2) how the Energy Reform will respond to those issues. The following commentary summarizes the Mexican government's views both as to a "diagnosis" of the problems in the electric power sector, and how the Energy Reform responds to the identified problems. We at Pillsbury add our own commentary on the Energy Reform and next steps.

## A New Model for Generation, Transmission, Distribution and Marketing of Electrical Energy

### Diagnosis

The price of electricity in Mexico is high and non-competitive. According to the legislative history of the Energy Reform, the average rates for electricity in Mexico are 25 percent higher than those in the United States, even with a subsidy, without which Mexico's rates would be 73 percent higher. This is hampering the Mexican economy, because electricity is an essential input for industry, commerce and services.

Currently, more than 20 percent of the energy generated for public service derives from fuel oil and diesel. These energy sources cost four to six times the cost of natural gas. The slow pace in replacing plants using these energy sources is largely due to CFE's exclusive right to provide electricity service to the public. While participation of the private sector is allowed, large scale projects depend on planning by the CFE and are limited by the restrictions imposed by the federal budget. This has become a bottleneck.

Another major challenge facing the sector is the lack of investment in the transmission grid. The CFE is planning an expansion of the transmission grid at an average rate per annum of 1.1 percent until 2026, which is lower than the expected growth in electricity demand in the country, estimated at 4.1 percent annually. It is necessary to increase the integration of the transmission grid and interconnect areas of the country with high potential for clean energy.

In relation to the distribution networks, there are significant inefficiencies in operations. Energy losses from the distribution networks in Mexico are almost twice the average of countries in the Organization for Economic Cooperation and Development (OECD). Including losses from billing and collection, more than 21 percent of the energy produced by the CFE is not paid for. As stated in the legislative history, no

electric power company in the world can sustain the loss of 21 percent of its production without reporting financial problems.

### The Energy Reform

Article 27 of the Mexican Constitution was amended regarding Mexico's national electrical system as follows: **"It corresponds exclusively to the Nation the planning and control of the national electrical system, as well as the public service of transmission and distribution of electrical energy; in these activities concessions shall not be granted, although the State may enter into agreements with private parties under the terms established by law, which will determine the manner in which private parties can participate in the other activities in the electrical industry."**

This is a significant change from the corresponding provisions in the Mexican Constitution prior to its amendment, which provided for a much broader exclusive role for the State: **"It corresponds exclusively to the Nation to generate, conduct, transform, distribute and store electrical energy for the purpose of providing a public service. In this area concessions shall not be granted to private parties and the Nation will make use of the property and natural resources that are required for such purposes."**

The key change is a greater role for the private sector. Within 120 days after the Energy Reform amendments to the Constitution become effective, i.e. by April 19, 2014, Congress is required to adopt updates to the law that will regulate the modalities of contracting whereby private parties, for the account of the State, will carry out, among other things, the financing, maintenance, management, operation and expansion of the infrastructure needed to carry out the public service of transmission and distribution. Trans. Art. 11.

The fact that the relevant Transitional Article speaks to the private sector's role in the "financing" and "expansion" of transmission and distribution infrastructure is significant. The private sector is clearly seen as the vehicle for modernizing and expanding Mexico's transmission grid and distribution systems. Participation by the private sector is also seen as a way for the State to obtain greater access to technology and expertise that will reduce operating costs and limit the loss of energy.

Another key role for the private sector will be in electricity generation and marketing. As specified in amended Article 27 of the Constitution, the implementing laws will regulate private sector contracts for transmission and distribution, and will also "determine the manner in which private parties can participate in the **other** activities in the electrical industry." (Emphasis added.) According to Mexican government commentary, the private sector will be permitted to participate in power generation and marketing under State regulation.

The commentary suggests that one aspect of private participation may be joint development of generation projects with CFE: "The participation of the private sector, along with CFE, in electricity generation will permit more flexibility. CFE will build new plants, modernize the generation base and increase its competitiveness." This does not exclude private parties acting on their own to build more generation capacity. It will be critical in evaluating the implementing legislation to analyze how that legislation favors or disfavors private sector joint ventures with CFE as opposed to independent generation by the private sector.

It appears that CFE will continue to be the owner of Mexico's transmission grid and distribution system, with private sector support for financing, maintenance, management, operation and expansion of this infrastructure through contracts between CFE and private parties. But ownership will be separated from

control and operation. Amended Article 28 of the Mexican Constitution provides for the establishment of a National Energy Control Center (*Centro Nacional de Control de Energía* or “CNCE”) on terms to be established by law. Transitional Article 16(b) provides that within 12 months following the effective date of the expected new Regulatory Law (*Ley Reglamentaria*) for the electric power industry to be adopted as part of the implementing legislation referred to above, the Mexican Executive must issue a decree whereby CNCE, which now exists as a part of CFE, will be reorganized as a decentralized public body responsible for operational control of the national electricity system and the wholesale electricity market.

With the transfer of control and operation to the reorganized CNCE, there will be an impartial third party, and not the CFE itself, which will endeavor to guarantee to **all** generators open and non-discriminatory access to the national transmission grid and to the public distribution systems, and will operate the wholesale electricity market. It is contemplated that improved access to transmission and distribution infrastructure and the wholesale power market for all generators will boost investment in new generation plants using clean and efficient technologies, including natural gas and renewables.

The Energy Reform contemplates that natural gas will play a greater role in the generation of electricity than at present. This is a key element of the strategy to reduce the cost of electricity, considering the present role of fuel oil and diesel fuel in generation, and the 4-6 cost multiple for these energy sources over natural gas. Mexico has multiple deposits of natural gas. However, according to the legislative history for the Energy Reform, production has been declining in recent years and Mexico today imports 30 percent of its consumption. The oil and gas elements of the Energy Reform (to be covered in a separate Client Advisory) provide for a greater involvement by the private sector such that, with multiple operators to extract the natural gas from Mexico’s own deposits, the electricity sector will be able to use this resource to produce cheaper and cleaner electricity.

In summary, the generation of electricity under the rules of open and fair access, coupled with the involvement of the private sector in the transmission and distribution sectors and in development of the associated infrastructure, will permit a reduction in the energy sector’s production costs and enable a greater role for clean, more efficient energy. The objective is for Mexican industry and households to have more power, at a better price and from less contaminating sources.

## CFE as a Productive State Enterprise in Electricity within a New Regulatory Framework

### Diagnosis

The Federal Electricity Commission, despite being one of the largest public companies in the country, is now facing great challenges. CFE reported that it suffered major losses in its capital over the last several years, i.e. 339 billion pesos from 2007 to June 2013, with remaining capital of 110 billion pesos. At current exchange rates (2/12/2014), the stated loss is US \$25.45 billion, with remaining capital of US \$8.26 billion. Also, CFE’s losses are accelerating. CFE’s own figures indicate that the continuation of recent trends would result in CFE having negative net capital at the close of 2014.

According to the Mexican government commentary, this is largely due to the current legal framework that prevents CFE from operating efficiently and from enhancing productivity in activities that would be more profitable and more suitable for the CFE.

Apart from its financial problems, CFE is not meeting the needs of the country – in transmission, distribution or generation. In part, this is because CFE has sole responsibility for providing energy and electricity supplies to the country, through its own transmission and distribution infrastructure, without the

possibility of complementing its efforts with those of third parties. While participation of the private sector is allowed in generation by means of independent power production, large scale projects depend on planning and design by the CFE, which are limited by the restrictions imposed by the federal budget. In addition, CFE has not been able to react quickly to the needs of the global electricity industry, which results in higher costs, low-productivity investments, and reduced competitiveness.

### **The Energy Reform**

In light of issues facing CFE, the Mexican government determined that it was necessary to change fundamentally the legal framework governing CFE. At the same time, Mexico would not permit privatization because of the certain political backlash. Accordingly, the government decided that it needed to “strengthen” CFE, while maintaining it as a national company.

Article 25 and Article 27 of the Constitution, as amended, together reserve to the Nation the planning and control of the national electrical system, and the public service of transmission and distribution of electrical energy, while permitting these functions to be carried out through “organisms” and “productive state enterprises” that are owned and controlled by the Federal Government. CFE itself is not specifically identified or referenced in the constitutional amendments, but Transitional Article 3 of the Energy Reform Decree provides that implementing law will establish the form and time period (which shall be not more than two years from publication of the Energy Reform Decree, i.e. by December 20, 2015) for the conversion of CFE into a productive state enterprise. This indicates that the converted CFE will continue to play an important role in those aspects of the electrical industry reserved to the Nation.

With respect to CFE as a productive state enterprise, the implementing law will establish the rules for its administration, organization, operation, procurement procedures and the other legal acts that it can undertake, as well as the system of remuneration for its staff, “to ensure effectiveness, efficiency, honesty, productivity, transparency and accountability, based on best practices,” and will identify other activities that CFE may perform. Mexican Constitution, as amended, Article 25. This means that the nature, scope and operation of CFE will be determined by the implementing law, which has not yet been submitted to Congress. CFE will be a “productive state enterprise,” but this term is not defined in the Constitution. Nevertheless, the Energy Reform Decree does establish the outlines of what will be included in the implementing legislation.

CFE’s purpose will be to create economic value and to increase revenue for the Nation, with a sense of fairness and social and environmental responsibility. It will have budgetary autonomy subject only to government control of its balance sheet and a cap on payroll in accordance with the terms set by Congress. CFE’s organization, administration and corporate structure are to conform to international best practices, ensuring technical and management autonomy, as well as a special procurement regime to obtain the best possible results in its activities. It will coordinate with the Ministry of Finance with the objective of financing its operations in such a way so as not to increase the cost of financing, or diminish the sources of funding, for the rest of the public sector. CFE will also benefit, on terms established by law, from a special regime for matters of acquisitions, leases, services and public works, budget, public debt, administrative liability and the other matters required to ensure the effective fulfillment of its purpose, so that it is allowed effectively to compete in the electric power sector. Trans. Art. 20.

It appears that the underlying rationale for the conversion of CFE to a productive state enterprise will be to set up an incentive structure so that its managers operate it like a business rather than a governmental entity. According to Mexican government commentary, the transformation of CFE to a productive state enterprise will generate incentives to raise its returns for the benefit of the Nation. At the same time, the

terms of the implementing legislation will cause it to adopt international best practices that will strengthen CFE as a key player in the electrical sector.

Although CFE will have greater independence and will be guided by market incentives, it will still be subject to a regulatory framework, which will be revised under the Energy Reform. As noted above, the reorganized CNCE will control and operate the transmission grid and distribution networks, and the wholesale electricity markets. Trans. Art. 16(b). Accordingly, CFE will be required to conform to the rules set by the CNCE for these elements of the national electricity system.

Further, the Ministry of Energy will set overall energy policy for the nation, and will establish the terms of strict separation between CFE as an operating entity and CNCE as a system operator to foster open access and efficient operation of the electric power sector. Trans. Art. 10(a).

Also, a reorganized Energy Regulatory Commission (*Comisión Reguladora de Electricidad*, or “CRE”) will be responsible for the regulation and granting of permits for generation, as well as wheeling tariffs for transmission and distribution. Trans. Art. 10(c). As to the reorganization, Congress is required to update the laws by April 19, 2014 to establish the CRE as a regulatory body with independent legal existence, having technical and managerial autonomy, and the right to obtain income from the taxes and revenues established by law for its services derived from its issuance and administration of permits, authorizations and contracts. Trans. Art. 12.

Finally, the Ministry of Finance, among other things, will establish economic conditions as to contracts contemplated in the Energy Reform Decree, which includes contracts in the electric power sector, relative to fiscal terms so that the Nation can receive, in a timely manner, income that will contribute to the long-term development of the country. Trans. Art. 10(d).

## Requirements for Local Content and Promotion of Mexican Companies

### Diagnosis

The opening of the electric power sector to private investment should contribute to the development and consolidation of Mexico’s domestic industry in a competitive environment. Accordingly, it is necessary to take measures to promote greater opportunities for participation in the sector by Mexican purveyors of goods and services.

### The Energy Reform

In order for private participation in the electric power sector to boost the participation of national and local supply chains, there must be requirements for national (Mexican) content. By April 19, 2014, the law must be updated to provide for the bases and the minimum percentages for national content as a condition to the execution of contracts in the electric power sector (and assignments in the case of oil and other hydrocarbons). The law must also establish mechanisms to promote national industry within the scope of the Energy Reform Decree. On the other hand, the Energy Reform Decree requires that any legal stipulations regarding national content must comply with the international treaties and commercial agreements to which Mexico is a party. Trans. Art. 7.

The implementing legislation will determine (1) how national content requirements are put in place, (2) what minimum percentages of national requirements will be required, and (3) what mechanisms will be used to promote national industry in the electric power sector. In developing this legislation, it will be important for the Mexican Congress to avoid running afoul of non-discrimination rules and other provisions

of international treaties. If and to the extent that energy industry issues are added to the agenda for the ongoing discussions of the Trans-Pacific Partnership with the United States and other Pacific Rim countries, these discussions may also impact how such national content requirements and mechanisms to promote the national industry are crafted and implemented. However, the objectives of the above-referenced provisions of the Energy Reform Decree are clear: To bring the benefits of the Energy Reform to Mexican companies, to create employment and to foster economic development at the national and regional levels.

## **Safety, Sustainability, Commitment to the Environment, and Use of Cleaner Fuels and Technologies.**

### **Diagnosis**

The Mexican government commentary declares that the State has a duty to guarantee the constitutional right to a healthy environment. Accordingly, measures are required to prevent environmental degradation, to punish those who cause damage to the environment and to obtain recompense for such damage. The State should also promote the use of clean energy in the electric power sector in order to reduce the environmental impact from electricity generation.

The commentary also notes that clean energy generation in many cases is not the easiest option for the development of new projects. Potential renewable resources are often found in remote areas of the country that require large transmission projects, while renewable technologies and project development present risks and challenges, both in the development process and in operations.

### **The Energy Reform**

The Energy Reform elevates to a constitutional level the principle of sustainability as one of the criteria under which the State will support and promote the business of the social and private sectors. Constitution, Art. 25, as amended. The Energy Reform also provides that the law shall encourage and protect activities carried out by the private sector and shall provide the conditions required so that the private sector's activity contributes to national economic development, promoting competitiveness and implementation of a national policy for sustainable industrial development. Constitution, Art. 25, as amended.

Under the implementing law, obligations for the use of clean energy and reduction of emissions will be established. Trans. Art. 17. Also, the Federal Executive, through the Ministry of Energy, shall include in the National Program for Sustainable use of Energy, within 365 days from the effective date of the Energy Reform Decree, i.e. by December 20, 2014, a transition strategy to promote the use of cleaner technologies and fuels. Trans. Art. 18. The Ministry of Energy commentary suggests that this will affect the conditions of operation and the financing of energy projects.

Also in support of the principle of sustainability, Congress is required to issue a law by April 19, 2014 that will regulate the recognition, exploration and exploitation of geothermal resources for the use of energy from below the surface within the limits of the national territory, in order to generate electricity. Trans. Art. 18.

Finally, the participation of the private sector in transmission and distribution, through contracts with CFE, is expected to expand and deepen the transmission grid and the distribution networks. This will provide capacity for more generation, including new generation developed by the private sector, which will use natural gas or renewable resources.



## Effective Measures to Combat Corruption

### Diagnosis

The opening of the energy sector to private investment creates opportunities for development and job creation. But the opening also creates opportunity for corruption as private parties compete for deals. Mexico seeks to overcome the popular cynicism that opportunities for the private sector in government procurement are available only to those who pay. Therefore the Energy Reform must be accompanied by measures that will prevent corruption, and impose penalties if corruption does occur.

In particular, it is of great importance to have effective mechanisms to combat corruption with respect to the award and administration of contracts. This must be carried out under conditions of probity and transparency in order to ensure maximum benefit for the country.

### The Energy Reform

Congress is required under the Energy Reform Decree to issue legislation by April 19, 2014 that will establish legal mechanisms to prevent, investigate, identify and severely punish contractors and public servants (and certain other parties involved in the oil and gas sector), as well as any person, whether natural or legal, public or private, national or foreign, that participates in the energy sector when such person engages in acts or omissions contrary to law, and specifically, among others, those that have as their objective or result, directly or indirectly, to influence the decision making of a public servant, staff or the directors of state productive enterprises in order to obtain a direct or indirect personal economic benefit. Trans. Art. 21. As such legislation is proposed and adopted, it will be important for industry participants to understand the interplay between this new legislation and other anti-corruption laws and regulations in Mexico, including, among others, the Federal Law on Anticorruption in Public Contracting adopted in 2012 and the more recent proposed constitutional reform (passed in the Mexican Senate but not yet adopted) relating to the anti-corruption enforcement regime.

Similarly, the Energy Reform Decree includes terms whereby the implementing law will provide that (1) contracts will include transparency clauses allowing any interested party to consult them; (2) there will be external audits; and (3) information on compensation, taxes and payments stipulated in the contracts will be disseminated. Trans. Art. 9. It appears that the primary focus of these terms is with respect to contracts that pertain to petroleum and other hydrocarbons. But the terms could readily be interpreted to apply to contracts in the electric power sector. The ultimate scope of the relevant provisions will depend on the terms of the implementing legislation.

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The Energy Reform will profoundly change all aspects of the electric power sector in Mexico. However, the detailed terms of the reform will not be known until the implementing legislation is adopted. Pillsbury will be monitoring closely the implementing legislation as it is submitted to the Mexican Congress and as it proceeds through the legislative process.

If you have any questions about the content of this advisory, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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