

Client Alert

Global Transactions Practice Group

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Taking the Road Best Travelled? *CFE seeks electric-gas “convergence”*

The recent constitutional reform of the Mexican energy sector will catapult Petróleos Mexicanos (Pemex) and Comisión Federal de Electricidad (CFE) into an unfamiliar competitive market environment. The rules of the game are not yet in place, but the former state monopolies over oil and gas exploration and production and electricity generation activities expect to compete in the broader national energy market side by side with other state and privately owned companies. This expectation has both Pemex and CFE scrambling to find a place in a new world and gain a competitive advantage against the newcomers.

Recent reports state that CFE will diversify its activities so that it will be not only an electricity generator, but also a transporter and seller of natural gas.¹ Indications are that CFE intends to obtain and sell natural gas transportation capacity through the integrated Sistema Nacional de Gasoductos (SNG) and the isolated Sistema Naco-Hermosillo (SNH) gas transmission systems, positioning itself to compete directly with Pemex in the sale of transportation capacity in such government-owned pipeline systems² and in the pipelines being developed by private companies and in which it has secured firm capacity rights as the main off-taker in power project development.³ According to CFE’s director Enrique Ochoa Reza, this structure will allow CFE to define prices and transportation terms and conditions in the Mexican natural gas business.

CFE’s approach is one that was tried, unsuccessfully, in the late 1990s by some U.S. electric utilities. The Duke Power and Consumers Power acquisitions of gas transportation companies once owned by PanEnergy are good examples. The power companies reasoned that “convergence” of the natural gas and electric power businesses was inevitable, that there were real synergies to be achieved by owning gas transportation, power generation and electric transmission assets, and that an owner of both gas transportation and electric power businesses would be able to benefit from those synergies and improve its competitive position.⁴

The theory sounded good and was a great sales pitch, but it ran into strong headwinds. Regulators would not allow the owners of gas transportation and electric power businesses to benefit from their “inside baseball” knowledge of the systems, and imposed transportation service provider standards of conduct specifically to deprive the owners of both gas and

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electric assets of the ability to communicate internally about their systems, operational matters and business opportunities; “optimization” of these assets through such internal communications became verboten. And then Enron imploded, causing the trading benefits many expected to result from electric-gas “convergence” to become hard to realize, taking down companies like PG&E Corporation which for years had owned both interstate gas transportation and electric transmission. Learning from this experience, in the U.S. today there is no significant cross-ownership of gas transportation and electric transmission and power production assets, and such is also the case in Canada.

CFE intends to pursue a model that has not worked elsewhere in North America, mostly because regulators would not let it work in the way the players had originally hoped. One could surmise one reason CFE seeks this advantage is because it can, and because it would like to avoid ceding too much of its ability to steer Mexico’s energy future, particularly where electricity generation is concerned. A cynic might even posit that CFE may have in mind retaining some of the control it has historically enjoyed over electric generation by indirect means, that is, through control of transportation through the direct or indirect control of an essential input, natural gas, the raw material with which to generate electricity.

If CFE maintains a de facto control of the gas pipelines bringing fuel to Mexico’s power generators, whether through ownership or the contractual hoarding of available capacity, it will have the ability to control dispatch, possibly favoring its positions and disfavoring those of independents. It is easy to affect electric power dispatch by curtailing gas supply availability. Power generators in California, like NRG, have been dealing with this since last winter.

It may be that CFE’s gambit is entirely understandable, and one that from the perspective of the incumbent monopolist is worth pursuing, given the prospect of new market entry by competitors. It is not unlikely, however, that the would-be competitors of CFE in the power generation (and even gas pipeline) businesses, will sooner or later become vocal about how letting CFE retain control of more gas pipelines will inevitably frustrate Mexico’s efforts to liberalize its energy markets and deter investment.

If CFE follows through on its clearly expressed plan, it will in due course request a gas transportation permit from the oil and gas midstream regulator, the Comisión Reguladora de Energía (CRE). If it is interested in creating “level playing field” conditions that will be conducive to the development of robust competition in Mexico’s natural gas transmission and power generation sectors, CRE should condition any approval of a gas transportation permit for CFE on that company’s establishment of complete and effective separation of CFE’s gas transmission management activities from its power generation and dispatch activities. CRE should also require complete transparency in CFE’s gas transportation utilization and management activities through real-time Internet postings of significant CFE gas transportation activities and capacity holdings, and should insist on the creation of a secondary market in gas transmission capacity in which such capacity could be traded, subject to appropriate price caps. And CRE should retain the power to audit CFE’s activities relative to gas transportation, particularly as it involves gas supply to CFE’s and its competitors’ electric generation facilities. Through such measures, CRE will be able to limit the extent to which the competitive alternatives promised by Mexico’s energy sector reforms are taken off the table before the reforms have a chance to work.

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¹ See <http://eleconomista.com.mx/industrias/2014/03/05/cfe-ingresara-negocio-gas>, accessed March 13, 2014, and http://www.conuee.gob.mx/wb/CONAE/noticias_5_marzo_2014, accessed March 13, 2014.

² To date, Pemex is the only company out of the two authorized to transport natural gas through the SNG and the NHS natural gas pipeline systems under open access Permits G/061/TRA/99 and G/062/TRA/99.

³ These include the recently-bid Los Ramones, Encino-Topolobampo, Sásabe-Guaymas, Guaymas-El Oro and El Oro-Mazatlán pipelines.

⁴ As per the Mexican energy reform, CFE's electricity-related activities will be limited to power generation. The government controlled Centro Nacional de Control de Energía (CENASE) will operate the electricity grid and wholesale market of electricity, and regulate open and non-discriminatory access to electricity transmission and distribution lines.