

GETTING THE DEAL THROUGH

Electricity Regulation

in 29 jurisdictions worldwide

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Chapter 16

Mexico

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POLICY

- 1 Broadly speaking, what is the governmental policy and legislative framework for the electricity sector?

Under Mexico's constitution, the generation, transmission, distribution and marketing of electric power for public service purposes is exclusively reserved to the federal government. This vertically integrated monopoly is controlled by two governmental entities, namely, the Comisión Federal de Electricidad (the CFE) and Luz y Fuerza del Centro (the LyFC). In 1992, partly as a result of Chapter VI of NAFTA, Mexico's Electric Power Public Utility Law was amended to allow private participation in the generation and transmission of power, establishing six permit modalities for the power-related activities that are excluded from the concept of public service. Since then, the government has encouraged the participation of private developers in the electricity sector. This has been mainly driven by the absence of sufficient governmental economic resources to meet the significant increase in demand during the past decade, and other considerations.

The federal government is looking to foster the participation of private companies in the electricity sector, particularly in power generation. During the period 2001–2010, the expected increase in the demand of electric power entails the addition of approximately 32,000MW, and the modernisation of the transmission and distribution systems. These activities entail investments of approximately US\$65 billion. The lack of sufficient public resources to cope with demand, along with the increasing participation of private investment allowed under the current legal framework and the minimum level of competition in the market, and the lack of scrutiny and transparency of CFE rates and service conditions, have become the leading factors supporting the need for a structural reform in the electricity sector. In 2001, the need for a structural reform was reiterated by the Supreme Court of Justice, which resolved a controversy between the executive branch and congress regarding an amendment to the Regulations of the Electric Power Utility Law, indicating, among others, that the constitutional grounds allowing private participation in the electricity sector should be clarified, and further inviting congress to consider whether the constitutional provisions regulating the electric power state monopoly have become questionable in light of the current economic and political needs of the country.

The federal government and all of the main political parties have proposed bills for such structural reform. Most of the proposed bills to restructure the electric power sector coincide in a number of critical aspects, namely:

- The creation of a wholesale market of energy
- The segregation of the national electric grid from the CFE
- The creation of an independent system operator in charge of dispatching the system and operating the national electric grid as a common carrier

- Increasing the authority of the Energy Regulatory Commission as the regulator of the electricity sector

ORGANISATION OF THE MARKET

- 2 In general, what is the organisational structure for the generation, transmission, distribution and sale of power (including electric energy and other electric products)?

The Mexican electricity sector may be divided into two main areas: the electric power public utility service, and the activities in which private participation is, to a limited extent, allowed.

The generation, transmission, distribution and sale of power for public service purposes is reserved to the federal government through two governmental bodies: the CFE and the LyFC. The CFE is the largest electric power utility company in Mexico. It is vertically integrated and serves the whole country except for a small region in the centre, which is served by the LyFC. The national electric system (which encompasses the generation, transmission and distribution facilities used in the provision of electric power public services) is also controlled by the CFE through its National Centre for Energy Control (CENACE).

The activities in which private participation is allowed include the following:

- **Independent power production (IPP):** private power generation facilities aimed at supplying all of their capacity and power output to the CFE
- **Self-supply:** private power generation facilities aimed at supplying power for self-supply purposes to the holder of the relevant self-supply power generation permit and its shareholders
- **Cogeneration:** private power cogeneration facilities aimed at supplying power to the establishments associated with the cogeneration process and the shareholders of the cogeneration company
- **Small-scale production:** (i) private power generation facilities with a capacity not exceeding 30MW, for export purposes or the supply of all the associated power output to the CFE, and (ii) private power generation facilities with a capacity not exceeding 1MW, developed through cooperatives or non-profit associations for the supply of power to rural communities or isolated areas
- **Export:** private power generation facilities for purposes of exporting all the associated power output
- **Import:** the import of power for self-supply purposes

The total installed capacity in the country in 2004 is 50,164 MW of which 90 per cent corresponds to CFE, 1.8 per cent to LyFC, and the rest is produced under the self-supply and cogeneration modalities. Since 1997, most of CFE's capacity has been successfully generated through IPPs (7,671 MW in seven years).

REGULATION OF ELECTRICITY UTILITIES: POWER GENERATION

- 3** What governmental or administrative authorisations are required to construct and operate generation facilities?

The main permit required to construct and operate generation facilities under any of the schemes in which private participation is allowed is the power generation permit granted by the Energy Regulatory Commission (the CRE), the federal agency in charge of applying the laws and regulations applicable to the generation of electric power by private parties, and the natural gas midstream and downstream sectors in Mexico. In addition to the legal and technical requirements established by law to obtain such permits, the CFE's opinion is required as part of the CRE's permit approval process.

In addition, power generation facilities require a federal environmental, safety and health impact authorisation granted by the Ministry of the Environment and Natural Resources (SEMARNAT), and if the use of national waters is involved, a concession granted by the National Waters Commission is typically required. Land use and local environmental permits are also required; they are granted by the state and municipal authorities of the place where the project is located.

- 4** What are the policies with respect to interconnection of generation to the transmission grid?

The holders of a power generation, export or import permit are allowed to either interconnect to the national electric system and use the CFE's wheeling services, which then acts as a contract carrier, or to build and operate their own transmission facilities.

The CFE is required by law to provide its wheeling services to all permit holders whenever the requested service is technically feasible under the principle of first come, first served. The CFE's wheeling services are provided pursuant to model contracts approved by the CRE, which also approves the methodology to calculate the applicable charges.

- 5** Does the governmental policy (or legislation) foster power generation based on alternative energy sources such as renewable energies or combined heat and power?

Power in Mexico is produced using the following sources: 34 per cent natural gas, 33 per cent fuel oil, 15 per cent coal, 10 per cent hydro, 5 per cent nuclear and 3 per cent others.

Recently, the Mexican government has encouraged combined cycle gas-fired power plants, making this type of technology a requirement in the international public tenders called by the CFE for the award of long-term contracts for the commitment of power generation capacity and the purchase and sale of associated power output. These power plants are developed by private companies under the IPP scheme. The public bidding procedures called by the CFE for the development of IPP projects (the IPP bids) have been undertaken as part of a large programme aimed at increasing Mexico's installed generation capacity. The process began in 1997, with AES having the first power plant developed under this scheme. Under the IPP programme, all of the financing and risk is placed on the sponsors, and payment is made to the contractor on a 'throughput basis'. At the outset, the IPP bids were pure 'output contracts', where the developer was barred from aggregating loads and building oversized plants. The developers were not able to take advantage of economies of scale, with minimum flexibility regarding the supply of natural gas. The contracts awarded under the IPP bids required the construction and operation of gas-fired combined-cycle power plants to be built and operated at a site

already predetermined by the CFE, with the gas supply already pre-arranged by the CFE with Pemex-Gas y Petroquímica Básica (PGPB), one of the operating subsidiaries of Pemex, a sister company of the CFE. After various consultations, the CFE revised the structure of the IPP bids, and now bidders are allowed to: (i) aggregate loads and propose the construction of an oversized plant, (ii) choose the site and interconnection points subject to certain conditions, and (iii) arrange for their own gas supply, with no restrictions for vertical integration. The first two to take the step of aggregating loads were Intergen with a 645MW power plant (the CFE required between 400 and 510MW), and Iberdrola with a 740MW power plant (the CFE originally required 495MW). To date, 22 projects have been awarded, with a total aggregating capacity of more than 7,671MW, and more projects are currently subject to bid. The excess power of the oversized plants, not earmarked for the CFE, can be allocated to a third user under a different power generation permit (eg self-supply, export).

The IPP bids have been successful so far not only because of the number and diversity of reputable power companies participating in such international tenders, but also because of the rates and competitiveness of the offers. All of the payments under the contracts awarded are being financed by resources of the federal government. One of the key issues affecting IPPs, however, is the lack of infrastructure to supply natural gas to the power plants being developed, the increasing scarcity of natural gas in Mexico, and the inconsistency between the terms of the natural gas supply services offered by PGPB and the fuel supply terms required to make these projects suitable for project finance purposes. As a result of that, LNG supply has become an important player in the supply of natural gas in Mexico.

The CRE, on the other hand, has developed model interconnection, wheeling and back-up power agreements specially crafted for permit holders developing projects under a 'renewable energy' scheme, which entail more favourable conditions to access the transmission grid of the national electric system. Hydroelectric, solar and wind projects are considered renewable energy projects for these purposes.

In addition, SEMARNAT and the Ministry of Energy (Sener) are currently working on the development and implementation of a programme for the certification of emission reductions, allowing renewable energy projects, under the Kyoto-Bonn-Marrakech protocol, to eventually participate in the emissions trading market.

Cogeneration and renewable energy projects are, on the other hand, normally able to obtain financing from regional development institutions and multilateral agencies.

REGULATION OF ELECTRICITY UTILITIES: TRANSMISSION

- 6** What governmental or administrative authorisations are required to construct and operate transmission networks?

Obtaining a power generation or import permit from the CRE entails the authorisation to construct and operate the necessary power transmission lines to implement the project. Normally, the environmental and municipal authorisations obtained in connection with a power generation facility also include the authorisation to construct the relevant power transmission lines, unless the extension of such power transmission lines entails crossing lands, lakes, rivers or other infrastructure facilities under the jurisdiction of other governmental agencies or bodies, in which case rights of way and crossing permits must be obtained.

The transmission lines constructed by power generation, export or import permit holders may only be used to transmit

the power generated or imported by such permit holders, which are not allowed to provide transmission services to third parties.

- 7** Who is eligible to obtain transmission services and what are the requirements that must be met to obtain access?

The only common carriers allowed to provide transmission services in Mexico are the CFE and the LyFC. Only the holders of a power generation, export or import permit have access to the CFE's and the LyFC's transmission services, subject to the technical viability of the requested wheeling services. For such purpose, an interconnection agreement and a transmission services agreement is entered between the CFE or the LyFC and the relevant permit holder, pursuant to the model agreements approved by the CRE.

- 8** Is there any tariff or other regulation regarding the rates, terms or conditions for the provision of transmission services?

Yes. The terms and conditions for the provision of transmission services by the CFE and the LyFC are regulated through the model agreements approved by the CRE. Likewise, the consideration payable for the CFE's transmission services is regulated through the Methodology for the Determination of Rates for Electric Power Transmission Services, which is also approved by the CRE.

REGULATION OF ELECTRICITY UTILITIES: DISTRIBUTION

- 9** What governmental or administrative authorisations are required to construct and operate distribution networks?

Under Mexican law, no private power distribution networks are allowed, except in the case of self-supply and cogeneration projects in which the permit holder has been formed as a self-supply company aimed at generating and distributing power to its shareholders. This scheme, however, is not considered a utility service.

- 10** Who is eligible to obtain access to the distribution grid and what are the requirements that must be met to obtain access?

Access to the CFE's or LyFC's distribution grid would be afforded to power generation or import permit holders as part of their transmission services. (See 7 above.)

- 11** Is there any tariff or other regulation regarding the rates, terms or conditions for the provision of distribution services?

See answers 8 and 13.

REGULATION OF ELECTRICITY UTILITIES: SALES OF POWER

- 12** What governmental or administrative authorisations are required for the sale of power to customers and which are the responsible authorities to grant such approvals?

In the strictest sense, only the CFE and the LyFC are allowed to sell power as a utility service.

Cogeneration and self-supply power generation permit holders, on the other hand, are allowed to supply power to their shareholders in exchange for a compensation. Under this premise, self-supply and cogeneration power plants have been developed in which the 'customers' are required to hold a nominal participation in the power generation company, in order to become authorised offtakers entitled to receive and use part of the facility's power output.

- 13** Is there any tariff or other regulation regarding power sales?

The tariffs for the electric power public utility services provided by the CFE and the LyFC are settled by the Ministry of Finance and Public Credit, with the participation of Sener and the Ministry of Economy, based on the proposals made by the CFE. The terms and conditions in which such service shall be provided are regulated in the Electric Power Public Utility Law and its Regulations; in addition, the specific terms and conditions of the contracts for the provision of the electric power public utility service are approved by the Ministry of Economy.

The supply of power by the holders of cogeneration and self-supply power generation permits to their shareholders is not regulated, and thus the terms, conditions and price for such supply of power may be freely negotiated and agreed by the parties.

- 14** To what extent are electricity utilities that sell power subject to public service obligations?

As previously mentioned, there are no private electricity utilities in Mexico. The CFE and the LyFC are the only electricity utilities in the country. The CFE and the LyFC are subject to public service obligations, and thus are required to provide power supply services to anyone requesting them, unless the service is not technically viable. When additional facilities are required in order to provide a requested service, an agreement shall be entered into between the party requesting the service and the CFE or the LyFC, as the case may be, in order to cover the cost of such facilities. The terms under which the cost of any required additional facilities shall be covered is regulated under the Regulations of the Electric Power Utility Law for Contributions.

REGULATORY AUTHORITIES

- 15** Which governmental or administrative authorities determine the regulatory policy with respect to the electric sector?

The CRE, Sener and the Ministry of Finance and Public Credit.

- 16** What is the scope of each regulator's authority?

The main powers given to the CRE are: the granting and enforcement of permits for the generation, import and export of power by private parties; the approval of the terms and conditions under which the CFE's and the LyFC's interconnection, wheeling and back-up supply services shall be provided; and the issuance of the methodology for the calculation of the considerations payable for the CFE's and the LyFC's wheeling services as common carriers.

Sener is in charge of the national energy policy, and is the governmental agency under whose supervision the CFE and the LyFC operate. Sener, however, does not grant or enforce any governmental permit regarding the development of the electricity sector. Although the minister of energy is the chairperson of the CFE's and Pemex's board of directors, the minister of energy does not have the sufficient leverage to regulate and control CFE and Pemex.

The role of the Ministry of Finance and Public Credit, on the other hand, is critical as it is the governmental agency authorised to fix the CFE's and LyFC's tariffs for the power supply public service, and it is the agency that authorises and controls the budgets of the CFE, LyFC and Pemex.

- 17** How is each regulator established and to what extent, if any, is it considered to be independent of the regulated business and of elected officials?

The CRE was created by administrative action, but was later fortified by the promulgation of the Law of the Energy Regulatory Commission, enacted by congress in 1995. The CRE is considered to be a quasi-independent agency of Sener. The CRE is a commission with revolving membership of five commissioners appointed by the president upon the recommendation of Sener. In general terms, the CRE's resolutions, directives, norms and permits are independent, and do not require the supervision or approval of a third agency. Unfortunately, the CRE is not completely independent from political influence, and does not have sufficient authority to regulate and control CFE and Pemex, the two governmental monopolies. As a result of the proposed electricity reform, the current administration is requesting congress to fortify the CRE's regulatory authority by making the agency more independent. In order to do so, proposals have been made whereby the appointment of commissioners would be previously approved by the senate, the removal of commissioners would only be possible for 'just cause' as established by law, that budgetary independence would be given to the CRE, and that the CRE will have the authority to approve CFE tariffs and service conditions.

- 18** To what extent can decisions of the regulator be challenged or appealed, and to whom? What are the grounds and procedures for appeal?

CRE decisions are challengeable through a reconsideration recourse which is resolved by the CRE itself, and, as a result of such legal action, the CRE may overturn or modify its previous decision. As a second stage of the process, the resolution issued by the CRE may be further challenged before the Federal Tribunal of Tax and Administrative Justice, which may resolve to annul the original challenged decision.

Furthermore, under Mexican law any act or omission by any governmental authority may be subject to judicial review through an amparo proceeding. An amparo proceeding is a special type of court proceeding wherein any person or entity in Mexico (national or foreign) may ask for judicial review in respect of acts or omissions of the government in violation of the petitioner's 'bill of rights'. An amparo proceeding is a combination of the common law 'injunction/writ of certiorari/writ of mandamus/writ of habeas corpus'. In this type of amparo proceeding, the petitioner typically requests: (i) an injunction against certain governmental acts, and (ii) a mandamus, that is, a request to the court to command the defendants (ie the governmental agencies involved in the challenged act) to redress the governmental acts in question, because such acts were performed in violation of the petitioner's bill of rights.

ACQUISITION AND MERGER CONTROL: COMPETITION

- 19** Which governmental body(ies), if any, have the authority to approve/disapprove mergers or other changes in control over businesses in the sector (including the acquisition of ownership interest in an electric utility) or acquisition of utility assets?

An acquisition of private generation/transmission facilities that entails the direct transfer of the assets and the relevant power generation or import permit requires the approval of the CRE and, if the transaction surpasses the monetary thresholds established under the Federal Law of Economic Competition to

qualify as a reportable transaction, the approval of the Federal Competition Commission (the CFC).

If there is no direct transfer of assets or permits, there are no change in control rules specifically applicable to businesses in the electricity sector in Mexico; thus, the main authorisation required for a change in control performed at a mezzanine level (that is, a change in control implemented through the acquisition of a participation in the company holding the relevant permit and owning the assets) would be the CFC's approval, which is applicable to all economic activities in general. In addition, if the change in control entails the acquisition by a foreign investor of 49 per cent or more of a company's capital previously held by Mexican investors, and the company's assets exceed the thresholds annually established by the Foreign Investment Commission, then the prior approval of the Foreign Investment Commission will also be required.

- 20** What criteria and procedures are applied with respect to the review of mergers, acquisitions and other transfers of control? How long does it typically take to obtain a decision approving or disapproving the transaction?

The approval by the CRE to transfer power generation/transmission assets and the related power generation or import permit is aimed at ensuring that the new permit holder meets all the requirements established under the Electric Power Public Utility Law from a legal/technical perspective, rather than an analysis of the antitrust or competitive aspects of the transaction. Accordingly, the procedure is similar in essence to that undertaken to grant a power generation or import permit, in which the CRE evaluates compliance with the applicable legal requirements to hold the requested permit, the technical qualifications of the facilities' operator in order to assure safety, and conformity with the power supply schemes in which private participation is permitted. These processes may take approximately three months.

The CFC's review of a reportable transaction is, on the other hand, aimed at analysing the possible anti-competitive effects that the transaction may have in the relevant market. The process of obtaining CFC approval entails the filing of a data-intensive pre-merger notification report, which is then analysed by the CFC, which normally requests the production and filing of additional information and documentation. Based on its analysis of the transaction, the CFC may approve the transaction as described in the pre-merger notification report, approve the transaction subject to compliance to certain conditions, or prohibit the transaction. Based on the waiting periods established by law, the process may take up to nine months in complex cases; however, these types of authorisations are normally obtained in approximately three to six months.

- 21** Which governmental or administrative authorities have the power to prevent or prosecute anti-competitive practices in the electricity sector (other than through the exercise of authority over acquisitions and mergers)?

The CFC is the Mexican federal agency empowered to prevent and prosecute anti-competitive practices in all economic sectors, including the electricity sector. The CFC may impose sanctions on the economic agents involved upon determining the existence of a punishable conduct (such as tie-in requirements, bid-rigging or other sorts of monopolistic practices) that causes harm to other economic agents vertically or horizontally located.

Since its creation in 1993, the CFC has been gradually developing an understanding of the energy sector and the important

role the federal agency has to play in enforcing antitrust laws and regulations in a market that, by its very nature, is monopsonistic—particularly with regard to the unparalleled situation of the Mexican energy industry, with two vertically integrated monopolies controlled by the government: Pemex, in the oil, gas and basic petrochemicals sectors, and the CFE, in the electricity sector.

22 What substantive standards are applied to determine whether a conduct is anti-competitive?

As in other jurisdictions, Mexican law establishes a series of conducts considered to be anti-competitive per se. Under a ‘rule of reason’ analysis, however, the CFC is empowered to prosecute and punish any conduct aimed at or having the effect of damaging or impeding the competition process or free concurrence in the production, processing, distribution and marketing of products or services in the relevant market, provided that the party undertaking such conduct is proven to have substantial power over the relevant market.

23 What authority does the governmental body have to preclude or remedy anti-competitive practices?

The main tool is the imposition of substantial fines by the CFC. Also, the CFC may require the relevant economic agent to cease any anti-competitive practice, and even order the divestment of assets. Once such sanctions have been conclusively established by the CFC, the relevant injured party may use such resolution for a prima facie case for the payment of actual and consequential damages before a Mexican court.

End-users, on the other hand, are entitled to cumulatively pursue a claim before the Federal Consumer Protection Agency (PROFECO) if the CFE’s or the LyFC’s power supply services violate the Federal Law of Consumer Protection.

INTERNATIONAL

24 Are there any special requirements or limitations on acquisitions of interests in the electricity sector by foreign companies?

No, except for the CFE and the LyFC in which direct private participation (national or foreign) is legally barred, since these two entities are exclusively controlled by the federal government.

25 What rules, if any, apply to cross-border electricity supply, especially interconnection issues (including cross-border fees)?

There are no cross-border fees applicable to cross-border electricity supply. The export and import of power by private parties, as previously mentioned, requires a permit granted by the CRE. Power import permits allow the importer to use the imported power exclusively for self-supply purposes, and thus imported power may not be sold or marketed. Power importers, on the other hand, are allowed to interconnect with the national electric system and use the CFE’s wheeling services, subject to the execution of the relevant contracts pursuant to the models approved by the CRE, and the payment of the corresponding wheeling rates.

The CFE and the LyFC, on the other hand, are allowed to import, export and make border-crossing exchanges of energy, subject to approval by Sener. Pursuant to the Electric Power Public Utility Law, Sener shall approve the importation of power by the CFE or the LyFC only if it is convenient from a technical or economic perspective, or if the cost of importing power is lower than the cost of obtaining such power in the country. Power exports by the CFE or the LyFC may be approved by Sener only in cases in which the national consumption of power is not affected and the exportation is technically and economically convenient, and in cases in which benefit from natural resources shared by Mexico and a neighbouring country is involved.

In addition, the import or export of power requires a special permit granted by the Ministry of Finance and Public Credit in connection with the metering facilities that must be used to measure the imported or exported power.

TRANSACTIONS BETWEEN AFFILIATES

26 What restrictions, if any, exist on transactions between electric utilities and their affiliates?

None.

27 Who enforces the affiliate restrictions and what are the sanctions for non-compliance?

Not applicable.

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