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A LEGAL ANALYSIS OF THE PROPOSED PRIVATIZATION OF THE MEXICAN ELECTRICITY INDUSTRY

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Mexico is facing an imminent crisis in the electricity industry due to increased need, aging infrastructure and limited economic resources. In February of 1999, sitting President Ernesto Zedillo proposed legislation that would open the electricity industry to private sector investment, both foreign and domestic. The nature of the proposed changes are best understood by first examining the existing Constitutional, statutory and regulatory framework restricting private ownership and then exploring the steps that have already been taken towards privatization. Finally, an analysis is necessary of what the future of the privatization of the electricity industry in Mexico may hold in light of its past.

I. THE MEXICAN CONSTITUTION AND THE ELECTRICAL ENERGY INDUSTRY

Article 28 of the Mexican Constitution prohibits monopolistic practices, economic concentrations, state monopolies and exemptions from otherwise applicable taxes.¹ Notwithstanding this general prohibition, Article 28, paragraph four, authorizes the Mexican state to exclusively control certain activities of national interest.² Consequently, the Mexican government has the exclusive right to: (1) own and operate "strategic areas" related to telegraphy, radio telegraphy, oil and fuels, basic petrochemicals, radioactive minerals and nuclear energy generation, electricity and other activities which may be considered strategic by applicable law; and (2) to regulate "priority areas" such as satellite communications and the railways.

In priority areas, the Mexican government has only supervisory and regulatory power to protect national sovereignty and security. The Mexican government also owns the communications network and grants permits or concessions to the private sector. In strategic areas, the state has an official monopoly to perform all related activities through public entities under the control of the government. Therefore, as provided by paragraph four of Article 28, all activities related to the power industry are reserved to the Mexican state.

As originally drafted by the Constitutional Congress of the 1917 Constitution, the provisions of Article 28 named only currency printing and minting, mail services, telegraphy and radio telegraphy as areas exclusively reserved to the Mexican Government.³ The electrical sector was designated as a strategic area for purposes of Article 28 of the Constitution in 1983, pursuant to the Constitutional amendment enacted on February 3rd of that year.⁴ Article 27 of the Constitution was amended

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1. Political Constitution of the United States of Mexico, Article 28.

2. *Ibid.*, Par. 4.

3. Political Constitution of the United States of Mexico (February 5, 1917), Article 28, Par. 4.

4. Official Gazette of the Federation (*Diario Oficial de la Federación* ("D.O."), Feb. 3, 1983. The D.O. is analogous to the federal register in the U.S.

on December 29, 1960 to establishing the government's exclusive right to generate, transform, distribute and supply electrical energy, for the purposes of "public service".⁵

"Public service" for Mexican Constitutional purposes is defined as the specialized activity performed by a person to satisfy, through continuous specific actions, a general or collective need for as long as such need persists.⁶ The key element in the concept of public service is the satisfaction of a public need, as opposed a private interest. Therefore, taken together, Articles 27 and 28 of the Constitution allow private non-governmental generation, conveyance, transformation, distribution and supply of electricity for private non-public needs.

It is important to note that paragraph four of Article 28 exempts governmental activities from being considered a monopoly only if they are in the statutorily created "strategic areas", i.e., functions directed at the performance of a public service. Therefore, it is safe to conclude that as long as the activities mentioned in Article 27 are performed in connection with the satisfaction of a private interest, Article 28 does not prohibit them.

II. THE REGULATORY FRAMEWORK

On August 24th of 1937, the Federal Electricity Commission ("CFE") was created by statutory enactment published on that date.⁷ The purpose of the CFE, as established by law, was to create, organize and manage the non-profit national system of generation, transmission and distribution of electrical energy for public and private consumption. The CFE's first project in 1938 generated 64 kilowatts of capacity. In 1942 CFE's generating capacity was increased to 837 kilowatts, and by 1946 the installed capacity of the CFE was approximately 45,594 kilowatts.⁸ In 1949, the CFE became a state owned autonomous entity.

As a result of tariff regulation and union problems, private companies operating in Mexico ceased to invest in the industry, making the CFE the only entity growing in the sector. In 1960, Article 27 of the Constitution was amended, prohibiting the private sector from participating in the electrical industry.⁹ The CFE then began the process, which ended in 1991, of merging and integrating the various private operations that had been active in the industry prior to their exclusion.

Although a state-owned autonomous entity, by law the CFE is regulated by the federal government, and is therefore essentially an arm of the executive branch under the supervision of the Ministry of Energy. According to the federal law on regulation of state entities, the Ministry of Energy oversees activities in the strategic areas (delineated in Article 28 of the Constitution) and public service (Article 27 of the Constitution). On December 22, 1975, the Law for the Public Service of

5. D.O., December 29, 1960

6. See Ernesto Gutiérrez y Gonzales, *Derecho Administrativo y Derecho Administrativo Estilo Mexicano*, Mexico City: Editorial "Porrua" (1993), at 734.

7. Law of the Federal Electric Commission, or *Ley de la Comisión Federal de Electricidad*, D.O., August 24, 1937.

8. Internal Data from Comisión Federal de Electricidad and Cemex, S.A. de C.V., Energy Department.

9. D.O., January 20, 1960.

Electrical Energy (LSPEE) was published and came into affect.¹⁰ Article 1 of this law is identical to the provisions of Article 27 of the Constitution regarding the government's monopoly on generation, conveyance, transformation, distribution and the supply of electricity as a public service.¹¹ Article 1 of the LSPEE also prohibits granting of concessions within the electrical industry and stipulates that the CFE is the only entity that can use and exploit the assets and other resources of the electrical industry. The LSPEE also created the legal framework which currently regulates the organization and operation of the CFE.¹²

III. THE PRIVATIZATION PROCESS

To understand the privatization process, one must be familiar with the characteristics of the electrical sector in Mexico. There are actually two entities operating the electrical sector: the CFE and the *Compañía de Luz y Fuerza del Centro* ("CLFC")¹³. Together, both serve nearly 20 million customers, which represent almost 90% of Mexico's population.¹⁴ The CFE, which supplies electricity to the entire country except Mexico City and the surrounding area, has a generation capacity of approximately 32,000 MW and serves 99% of the Mexican territory and 75% of the customers.¹⁵ The CLFC is basically only a distribution entity, as its generating capacity meets only 5% of it's customers needs.¹⁶ It serves 4.6 million customers in the urban area of Mexico City, and buys 30% of the electricity generated by the CFE nationally.¹⁷

Mexico's methods of producing electricity are varied. Fifty-four percent of the installed capacity is generated by gas turbines, combine cycles and conventional steam plants.¹⁸ Forty-nine percent is hydraulically generated, half of which is generated in southeast of Mexico.¹⁹ Seven percent of the generation is from dual capacity plants (oil or coal).²⁰ The remaining power is either nuclear or geothermal.²¹

The primary challenges that the electrical sector and the CFE will face in the future are:

- (i) Meeting the demand for increased installed capacity. It is estimated that the future demand will increase from 1,000 to 1,500 MW per year.²² In

10. Law for the Public Service of Electrical Energy (LSPEE), or *Ley del Servicio Público de Energía Eléctrica*, D.O., December 22, 1975.

11. *Id.*, Article 1.

12. *Id.*

13. Light and Power Company of the Center (*Compañía de Luz y Fuerza del Centro*).

14. Internal Data from Comisión Federal de Electricidad and Cemex, S.A. de C.V., Energy Department.

15. *Id.*

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.*

22. *Id.*

order to reach the proposed goals in distribution and transmission, U.S.\$600,000,000 in new projects will be needed.²³

- (ii) Improving the quality of the service.
- (iii) Ensuring the profitability of the sector in order to make it financially viable; and
- (iv) Promoting a more efficient operation through regulatory changes.

The most important problem the CFE and the Mexican electrical sector face is obtaining the financing for the investment needed to increase the installed capacity, provide maintenance and improve the quality of the service.

The Mexican government has recognized that the private sector must participate in the electrical industry to adequately satisfy such needs and promote the globalization of the economy. Hence, Congress amended the Federal Law for the Public Service of Electric Energy.²⁴

The Constitution currently grants the Mexican government the monopoly to generate, transform, distribute and supply electrical energy for public service and prohibits the granting of concessions. A concession can be defined as an administrative act whereby the state allows a private party to render a public service, or grants such a party the use and exploitation of public property, under terms and conditions established by the state to ensure the efficient performance of the public service and the employment of public property for the benefit of society.²⁵ It is clear that, in general terms, only the state is empowered to participate in the energy sector to satisfy the needs of the people of Mexico.

As long as an activity is performed to satisfy a private interest, it does not fall within the Constitutional prohibition. The Federal Law for the Public Service of Electrical Energy (LSPEE) circumvents the concession problem by establishing in Article 3 that:

"The following are deemed to not be Public Services:

- (i) The generation of electricity for self-supply, co-generation and small-scale production.
- (ii) The generation of electricity by independent producers to be sold to the CFE.
- (iii) The generation of electricity for exportation, as long as such electricity results from co-generation, independent production or small scale production.
- (iv) The importation of electricity by individuals or corporations to be used for the satisfaction of their own needs.
- (v) The generation of electricity to be used in emergencies as a result of the interruption in the public service of electrical energy."²⁶

23. *Id.*

24. Decree to reform the Law for the Public Service of Electrical Energy, D.O., December 22, 1992 (The amendment to the LSPEE was a part of the Reforms to Articles 9, 10, 13, 26, 27, 28, 29, 31, 36, 36 bis, 37, 38, 39, 40, 42, 44, 45 and 46.)

25. Gutiérrez y González, *supra* note 6, at 716.

26. Amendment to LSPEE, *supra* note 24.

These provisions therefore authorize the Ministry of Energy, Mines and State Industries ("the Ministry") to grant permits with the prior approval of the CFE.²⁷ It is important to note that the law allows permits, not concessions.²⁸ In Mexican law a permit is the authorization required to exercise a limited right. Private participation in the electrical sector is permitted as long as it is not for public service. Therefore, the type of administrative authorization for private electrical generation under the LSPEE is a permit, not a concession.

The amendment of the Law for the Public Service of Electrical Energy in 1992 was the first step towards the privatization of the Mexican electrical sector.²⁹ The extent of those reforms are understood by examining the principles that regulate each of the activities contemplated by Article 3 of the LSPEE.

*a. Self-Supply of Electricity requirements:*³⁰

- (i) The self-supply of electricity shall be to meet the private needs of individuals or corporations and should not affect national interests.
- (ii) When there are various applicants for self-supply from a given power plant, they will be co-owners of the facility or they will form the corporation with the purpose of the generation of electricity to satisfy the self-supply needs of the shareholders. In the latter case, the corporation shall not deliver energy to third parties that were not shareholders at the time the permit was granted. This includes any expansion plans, except when the assignment of the shares or the amendment to the original plans are approved.
- (iii) The applicants shall make any excess energy available to the CFE.

*b. Co-generation of Electricity requirements:*³¹

- (i) The electricity should be produced in conjunction with steam or another type of secondary thermal energy, or both. Thermal energy or fuels produced in production processes are to be utilized to produce electricity directly or indirectly.
- (ii) The electricity should be dedicated to satisfy the requirements of the facilities associated with the co-generation, as long as the energy and economic efficiency of the entire process is improved, and provided that it is more efficient to generate the energy in this mode rather than by conventional plants. A permit holder may not be the operator of the process that co-generates the electricity.
- (iii) Any excess energy must be made available to the CFE.

27. *Id.*

28. *Id.*, Article 36.

29. Amendment to LSPEE, *supra* note 24.

30. *Id.*, Article 36.

31. *Id.*

*c. Independent Production Requirements.*³²

All electricity produced under an independent production permit must be sold to the CFE, who shall be obligated to buy it on agreed upon terms and conditions. The permit requirements are:

- (i) The applicants can be individuals or corporations, incorporated according to Mexican law; domiciled in Mexico and in compliance with all applicable legal requirements.
- (ii) The respective projects should be compatible with the general plans or programs of the CFE or their equivalent, except in cases where the production is for export.
- (iii) The applicants must enter into long term sales agreements with the CFE or stipulate to the Ministry to export all or part of the production.

*d. Small Scale Production Requirements.*³³

- (i) The applicants must be Mexican individuals or corporations, incorporated according to Mexican law, domiciled in Mexico and comply with all applicable requirements.
- (ii) All the energy should be sold to the CFE and the installed capacity in a given area (to be determined by the Ministry) is not to exceed 30 MW.
- (iii) A second alternative, under a self-supply mode, would allow applicants to use the production for the benefit of a small rural community, or isolated areas without electricity if those interested form consumer cooperatives, are co-owners, form associations or corporations, or formalize joint and several corporation agreements. For such purposes those projects shall not exceed a capacity of one MW.

*e. Import and export of electricity requirements.*³⁴

- (i) The permit can only cover transmission, transformation and delivery.
- (ii) Temporary use of the grid is subject to CFE approval.
- (iii) The Ministry of Energy may grant the permits for one or several of the activities mentioned in (i), with the approval of the CFE, and impose other requirements.

It is crucial to note that for all permits the fundamental principle is to avoid any possibility of directly servicing third parties which would be public service and require a concession. However, the LSPEE creates the possibility of projects to supply the CFE and thereby assist in the development of the installed capacity required to meet the growth in demand expected in future years. To assure an adequate and fair treatment in sales to the CFE, and to safeguard the feasibility of the projects, the law establishes that the CFE shall give preference to electricity produced at a lower cost with the best stability, quality and safety, thereby promoting efficiency among producers.³⁵

32. *Id.*

33. *Id.*

34. *Id.*

35. *Id.*

Also relevant is Article 5 of the Foreign Investment Law (FIL) which establishes the activities which are exclusively reserved to the state, including "electricity", and therefore closed to foreign investment.³⁶ It is important to note that the FIL uses the word "electricity," and may be understood to include all activities related thereto. However, regulations issued pursuant to Article 2 of the FIL expressly exclude the above mentioned permit activities from the foreign investment law's prohibitions.³⁷ The regulations issued by the President may be unconstitutional if found to exceed the limits of the FIL as enacted by Congress.³⁸ Consequently, some may argue that to exclude certain activities from the scope of the FIL, the law must be amended by Congress, not merely regulated by the Executive.

On December 31, 1995 the law creating the Energy Regulatory Commission (CRE) was enacted.³⁹ The CRE is an entity derived from the Ministry of Energy and it is granted technical and operative autonomy. By doing this, the government is trying to assure the participants that the terms and conditions will be decided upon objective criteria. The CRE will, among other things, verify that in rendering the public service of the provision of energy, the electricity that can be acquired at the lowest cost and that best insures stability, quality and safety is the one which is used. The CRE will also approve the basis to determine the payment for the electricity to be required by the CFE, as well as those to be used to establish the payment for the wheeling, transformation, and delivery of energy. Finally, the CRE will be the entity to grant and revoke the permits for the regulated activities that now can be undertaken by the private sector. Therefore, the Ministry is no longer authorized to issue such permits.

IV. THE FUTURE

On February 2, 1999 the President sent Congress an initiative to amend Articles 27 and 28 of the Constitution to eliminate the state monopoly on the generation, transformation, conveyance, and distribution of electricity for public service and to remove them from the list of strategic activities.⁴⁰ The proposed amendments provide that the state will be the exclusive owner and operator of the transmission network (grid).

The presidential initiative is based upon the following premises:⁴¹

- (i) The supply of electricity is a determining factor in allowing the economy to grow and such supply should provide electricity with adequate safety and reliability and at a competitive cost.

36. Law for Foreign Investment, or *Ley de Inversión Extranjera*, D.O., October 23, 1996.

37. Regulation of the Law for Foreign Investment, or *Reglamento de la Ley de Inversión Extranjera*, D.O., September 8, 1998.

38. Initiative to reform Articles 27 and 28 of the Constitution, (*Carta Iniciativa. Propuesta de Cambio Estructural de la Industria Eléctrica en México*.) D.O., Feb. 2, 1999. ("presidential Initiative") Office of the President, February 2, 1999.

39. Law for the Energy Regulatory Commission, or *Ley de la Comisión Reguladora de Energía*, D.O., December 31, 1995.

40. Presidential Initiative, *supra* note 38.

41. *Id.*

- (ii) The supply of energy is also basic for the achievement of adequate living conditions for the Mexican population.
- (iii) At the end of the nineteenth century, electricity was being generated by the private sector for self-consumption.
- (iv) The limited commercialized electrical generation was insufficient to cover the demand. Furthermore, the absence of an adequate regulatory scheme has caused uncoordinated development.
- (v) During the 1920's, the first effort to reorder the electric industry was implemented with the creation of the *Compañía de Luz y Fuerza*, the entity that preceded the CFE.
- (vi) In 1926 the Electric Code was enacted and in 1934 Article 73, Section 10 of the Constitution was amended in order to grant Congress the exclusive right to legislate the electrical industry.⁴²
- (vii) In 1960 the electrical industry was nationalized by constitutional amendment.⁴³ By then, the federal government had acquired the common stock of all the private companies that were operating in the sector and had strengthened the position of the CFE.
- (viii) As a result of the consolidation and acquisition of the various corporations that were in operation in the central region of the country, the *Compañía de Luz y Fuerza del Centro* was created. This corporation continued to operate independently of the CFE.
- (ix) During the 1970s and at the insistence of the CFE, the unification of the various electrical systems was completed and the uniform national frequency was set at 60 cycles per second. This allowed for the standardization of equipment and improvement in efficiency within the industrial sector.
- (x) High inflation without corresponding price adjustments caused the sector to suffer a serious loss of capital. This decapitalization, in conjunction with a growing subsidy for consumption, limited the growth of the sector to that which was subsidized with public funds.

As previously mentioned, the 1992 reforms allowed limited private sector participation in all those activities not deemed to be public service. Nonetheless, due to the remaining limitations, the participation of the private sector is very limited. Although the installed capacities of 36,000 MW are sufficient for now, during the next year the supply of electricity will have to be substantially increased and efficiency will also need to improve. An estimated investment of 250,000,000 pesos in 1999 alone will be needed to meet Mexico's growth and modernization needs.⁴⁴ Financing this investment exclusively with public funds would require foregoing other important investments in education and social welfare.

The proposed constitutional reform leaves the state the exclusive operational control of the grid and opens all other activities to private investment. The proposal would also amend Article 28 of the Constitution, leaving operational control as a

42. D.O., January 18, 1935.

43. Amendment to Article 27 of the Constitution, *supra* note 5.

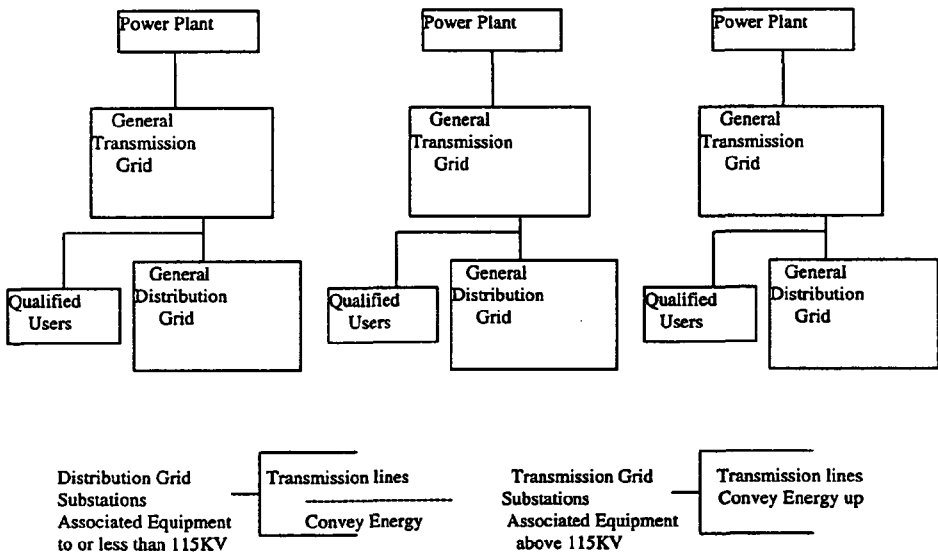
44. Presidential Initiative, *supra* note 38.

strategic activity and redefining all other activities as priority areas.⁴⁵ The reform seeks only to establish the constitutional framework authorizing the creation of regulations. Therefore, if the proposed constitutional amendment is approved, additional reforms to the applicable laws would be required.

The preliminary draft of the additional legislation already exists.⁴⁶ The new law will be the Law of the Electrical Industry, as opposed to the existing one based on the concept of public service. It would define the electrical industry to include the generation, transmission, distribution and commercialization of electricity. The proposed law further reserves exclusive regulatory authority to the state. The state will also control the operation of the national transmission grid and such control will be considered a strategic area. All other activities will be open to all sectors of the economy.

The CFE will be entrusted with the operation, supervision, maintenance and development of the national transmission grid (including the general transmission grid, the general distribution networks, and lines to the facilities of qualified users).

In general terms, the law contemplates the following structure:



45. *Id.*

46. The preliminary draft has been prepared by the Ministry of Energy in conjunction with the private sector.

The proposed law also requires that all of those granted a concession to provide energy services to currently unserved rural and low-income areas. A wholesale market for electricity to be called the *Mercado Electrica Mayorista* (MEM) will be created and be operated by a new state agency called the National Electric System Operations Center (NESOC). The NESOC will determine which power plants will be contracted to satisfy the demand based on cost, efficiency, reliability and safety. Furthermore, the NESOC will also act as a clearing center for billings and payments.

The proposed law also contemplates the possibility of a commodities market in electricity. If the power plants are owned by the state, the power plants could be constructed under permits or concessions. The energy produced will be sold through the wholesale market. Distribution as a public service will be performed under concessions and distributors will buy energy on the wholesale market. Energy traders might operate under permit and could buy energy and sell it to distributors or qualified users and act as brokers or commission agents in the purchase and sale of energy.

The privatization process will include various stages such as the reorganization of the CFE and Compañía de Luz y Fuerza, the opening of the electrical sector to private investors for the development of new projects and the opening of public entities to the participation of the private sector in general. The proposed Constitutional reform is still pending in Congress and has not yet been submitted for discussion and analysis due mainly to political considerations.