Privatization: A Case Analysis of Special Legal Issues

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I. INTRODUCTION

The past wave of privatizations has contributed to a redefinition of the role of government worldwide and the competitive landscape of national economies. Recent experiences provide a wealth of material to reflect upon the topic of privatizations with deeper analysis and the benefit of hindsight.

It is widely accepted that privatizations can contribute to improve the performance and allocation of assets in an economy. According to conventional wisdom, privatization invariably improves corporate governance, management and performance. Despite these benefits, experience demonstrates that each privatization poses a unique set of problems and challenges.

II. BACKGROUND TO MEXICO'S PRIVATIZATION PROCESS

One of the countries that implemented an ambitious privatization program, and continues to do so, is Mexico. Privatization was one of the key elements of economic reform in Mexico during the past decade. It was seen as a necessary condition to permanently correct the deficient nature of public finances and develop the productive sector. The sale, liquidation, merger or transfer of small government entities started in 1983. The aim was to develop expertise before moving into the privatization of larger entities.¹

Another action taken by Mexico to reduce government participation in the economy was to permit private investment in activities formerly restricted to government control such as railroads, and natural gas transportation and distribution. Private investment has taken the place of government spending in many areas of the Mexican economy. In sum, the type of industries privatized or where private investment participation has been encouraged includes steel, telecommunications, airports, banks, electricity, ports, highways, radio, television, water and railways, among others.²

¹ PEDRO ASPE ARMELLA, EL CAMINO MEXICANO DE LA TRANSFORMACIÓN ECONÓMICA, FONDO DE CULTURA ECONÓMICA (1993).
² For further clarification refer to table one and table two.
### TABLE 1

**NUMBER OF STATE OWNED ENTERPRISES PRIVATIZED 1970-96**

<table>
<thead>
<tr>
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<tr>
<td></td>
<td>177</td>
<td>504</td>
<td>1,155</td>
<td>412</td>
<td>219</td>
<td>195</td>
</tr>
</tbody>
</table>

**TOTAL VALUE OF ENTERPRISES SOLD**

<table>
<thead>
<tr>
<th>Year Range</th>
<th>1983-88</th>
<th>1989-94</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$942 million USD</td>
<td>$23.097 billion USD</td>
</tr>
</tbody>
</table>

### TABLE 2

**GOVERNMENT OWNED ENTERPRISES 1982-1994**

<table>
<thead>
<tr>
<th>Year</th>
<th>Government Entities</th>
<th>Majority Ownership</th>
<th>Trusts Ownership</th>
<th>Minority Ownership</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1982</td>
<td>102</td>
<td>744</td>
<td>231</td>
<td>78</td>
</tr>
<tr>
<td></td>
<td>1983</td>
<td>97</td>
<td>700</td>
<td>199</td>
<td>78</td>
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<tr>
<td></td>
<td>1984</td>
<td>95</td>
<td>703</td>
<td>173</td>
<td>78</td>
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<tr>
<td></td>
<td>1985</td>
<td>96</td>
<td>629</td>
<td>147</td>
<td>69</td>
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<tr>
<td></td>
<td>1986</td>
<td>94</td>
<td>528</td>
<td>108</td>
<td>7</td>
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<tr>
<td></td>
<td>1987</td>
<td>94</td>
<td>437</td>
<td>83</td>
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<td></td>
<td>1988</td>
<td>89</td>
<td>252</td>
<td>71</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>1989</td>
<td>88</td>
<td>229</td>
<td>62</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>1990</td>
<td>82</td>
<td>147</td>
<td>51</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>1991</td>
<td>78</td>
<td>120</td>
<td>43</td>
<td>0</td>
</tr>
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<td>1992</td>
<td>82</td>
<td>100</td>
<td>35</td>
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<td></td>
<td>1993</td>
<td>82</td>
<td>98</td>
<td>30</td>
<td>0</td>
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<tr>
<td></td>
<td>1994</td>
<td>82</td>
<td>107</td>
<td>30</td>
<td>0</td>
</tr>
</tbody>
</table>

5. The increase in the number of entities is due to the creation of the "Administraciones Portuarias Integradas" which are explained in connection with the privatization of ports.
Mexico has also made a significant effort to attract foreign investment. As competition from national economies for foreign investment flows increased during the past two decades, it became increasingly evident that a new legal framework was needed to attract foreign investment. The Foreign Investment Law of 1973⁶, reflected the prevailing view at the time, that foreign investment should be scrutinized and controlled. It was basically a restrictive law, which did not encourage the flow of foreign investment. In 1989, the Mexican government issued a set of regulations⁷ aimed at liberalizing the implementation of the Foreign Investment Law of 1973. Subsequently, in 1993 a new law was enacted to update the legal framework applicable to foreign investment.⁸ The 1993 Law incorporated many of the provisions found in the 1989 Regulations and, in addition, further liberalized the foreign investment legal regime.

To facilitate foreign investment, the 1993 Law included, among others: (i) the elimination of the requirement for foreigners to obtain prior authorization to exceed forty-nine percent ownership in most areas of commerce, except in those areas specifically limited by the Mexican Constitution or special legislation; (ii) the elimination of certain performance requirements previously imposed on foreign owned enterprises, such as the need to maintain a positive balance of foreign exchange, the need to make additional investments in fixed assets, or to export products at a certain level; and (iii) the possibility of obtaining a waiver of the need to comply with commitments or performance requirements pursuant to the 1989 Regulations when securing approval for the original investment.

The privatization process in Mexico has been tested under extreme circumstances of the current economic crisis. Mexico, once considered one of the leading examples of the privatization process in Latin America, has experienced the worst economic crisis since the great depression, with a decline in its Gross National Product of 6.7% during 1995.

The December 1994 peso devaluation, the period of high interest rates and the economic recession that followed had significant repercussions on the Mexican banking and financial system. In trying to avoid a banking crisis that could further increase the contraction in the real economy and set the stage for a recovery of the financial system, the government took a number of actions. Among them are: amendments to the legal framework for foreign ownership of banks, reinforcement of supervision, the managerial intervention of troubled banks, programs for recapitalizing banks, and the introduction of inflation-indexed lending and the provision of indexed funding to banks that proved unable to weather the crisis and its aftermath. The combination of these measures has permitted banks and the banking and payments system as a whole to continue to operate and recover despite a very sharp contraction in the real economy.⁹
III. GOVERNMENT PARTICIPATION IN THE ECONOMY AND PRIVATIZATION

Economic literature has documented cases in which participation of government in the economy might be necessary and justified. The most common examples of government participation have included situations when there are insufficient tax revenues, when the size of the market is insufficient to maintain a competitive structure, or when private investment is unavailable. Some of these conditions were present in Mexico during the first decades of the century and led the government to participate in capital intensive industries, such as steel works and railroads.

In Mexico, government participation expanded as nationalistic rhetoric grew. This led the government to distort the purpose of government participation. The government acquired ownership of movie theaters, hotels, airlines, and other unrelated businesses. The result was that the government owned sectors which had no unifying strategy, and economic resources were diverted to subsidize state owned enterprises. Nationalistic rhetoric also prevented private investment in many areas of the economy, resulting in the government running up a considerable external debt to finance investment in those areas.

Another perverse effect was that negative incentives were built into the system for private companies to respond to external shocks. After all, if they failed, the worst case scenario was that the government would nationalize them. By rescuing failed enterprises, the government contributed to create a culture of lack of accountability among certain groups in the private sector.

IV. SOME LESSONS FROM THE PRIVATIZATION PROCESS OF MEXICO

The former head of the privatization program in Mexico used an anecdote to illustrate the folly of indiscriminate government participation in the economy. When the government subsidized Aceros Monterrey, a steel company, 5,000 jobs were saved. However, 10,000 jobs could have been created if, instead of subsidizing Aceros Monterrey, the government had wisely invested the same amount of money in another area of the economy, such as highway development or other infrastructure projects. Such an investment would have doubled the number of highways in Mexico.

Unfortunately, many mistakes like those made with Aceros have occurred. Opportunities have been missed by funneling resources into unproductive businesses instead of investing in education, health and basic infrastructure. One of the most significant privatizations was the privatization of the banking system.

President Lopez Portillo nationalized the banking system during the last year of his office and banks remained in the hands of government until the privatization of the banking system under President Salinas in 1991 and 1992. The privatization of the banks yielded approximately twelve billion USD, yet the privatization was laced with problems.

It has been argued that the high premiums at which banks were privatized during 1991 and 1992 was one of the main reasons for their subsequent financial distress. In addition, the 1994 currency crisis and the contraction in the economy hit the relatively new banking system while it was still undergoing a process of consolida-
tion with both the banks and the supervisory authorities working to improve their institutional capacity.\textsuperscript{10}

Another reason for the failure of banks rested in flaws in credit assessment. Unaccustomed to lending to the private sector, banks were lending too much to borrowers of doubtful quality. Traditionally, a rapid expansion of lending to private enterprises usually takes place at the cost of a drop-off in portfolio quality, and Mexico was no exception. After the crisis, the drop-off in asset quality and the inability of borrowers to meet their financial obligations required banks to increase substantially their loan reserves and provisions to cover their actual and potential loan losses.\textsuperscript{11}

The end result was high prices paid for the banks contributed to their subsequent financial distress. Banks developed dangerous mismatches between the short-term foreign financing and escalating bad loan portfolios. Because the banking problem created a large increase in bad debts, several government actions were implemented to avoid the system from breaking despite a big devaluation and a major recession.\textsuperscript{12}

The government initiated, among others: increased regulation and supervision; bank fund for savings protection ("FOBAPROA") participation; relaxation of foreign investment restrictions; management interventions; increased provisions; capitalization programs; and debt restructuring programs (UDI scheme).

The government intervened in several banks that failed to comply with applicable regulations and specific recommendations from financial authorities. The motivation of the government was to avoid greater harm to the financial system at large and therefore implemented a temporary capitalization program to ensure banks were able to meet their obligations with depositors. Additionally, debt restructuring programs for small and mid-sized were specially designed to support debtors in the payment of credit card, working-capital, loans, mortgages and car loans which represent a significant portion of bad debts in the banking sector.

Another significant change in Mexico was the privatization of Telefonos de Mexico ("Telmex"). The privatization of Telmex in 1991, marked the discovery of Latin American equities for mainstream foreign investors. Before Telmex, coordinators of the privatization had to take Mexican officials to see investors and explain where the country was and what its reforms meant. After Telmex, investors could not get enough Latin American stocks. As a result, American and European money poured into Mexican equities.\textsuperscript{13}

Prior to the privatization of Telmex, the government had a dual role as regulator and owner. In preparation for its sale, the company was restructured. Modifications were made to the union agreement, and fiscal reform was done with respect to the telephone tax, repurchase of debt, sale of accounts receivable, and bond issuance and rate adjustments.

Mexican control of the company was a requisite objective of the privatization. The key element in the financial scheme was the issuance of a limited voting stock, resulting in a strategic group which would have control over the management of the company. Later, the public auction procedure took place, and in order to participate,

\begin{thebibliography}{9}
\bibitem{10} Id. at 25.
\bibitem{11} Id. at 26-27.
\bibitem{12} Id. at 27.
\bibitem{13} The Rollercoaster Region, (economic instability in Latin America) (Latin America Survey), The Economist, Vol. 337, No. 7944. (December 9, 1995).
\end{thebibliography}
investors needed to pre-qualify. Finally a public offering was made in the world markets.

V. PRIVATIZATIONS DURING THE PRESENT ADMINISTRATION

During the administration of President Zedillo, the privatization process of public enterprises has continued. The failure of some banks to meet their financial obligations and their subsequent rescue by the government to protect the public and the stability of financial markets, have initiated a second round of bank privatizations. Hopefully, the mistakes incurred during the first round have been assimilated, so that such mistakes are not repeated.

It is important to highlight that the privatization taking place during this administration has required significant modifications to the existing legal framework. The Constitution has been amended to permit foreign investment in railroads and satellites. Also new laws have been enacted to regulate ports, railroads, civil aviation, airports and federal telecommunications. Modifications to the legal framework add to the complexity of implementing a privatization process. The following is an overview of the privatizations that are taking place during this administration to illustrate the changes.

A. Railroads

In February of 1995, the door opened to private participation in the government owned monopoly over railroads. The amendment of article 28 of the Mexican Constitution, reclassified railroad activity to permit private investment. Later, in May of 1995, the Law Regulating Railroad Activity\textsuperscript{14} was enacted, to provide a framework for this activity. Finally, in November of 1995, the General Guidelines for the Participation of Private Investment in the Railroad System were issued by the Ministry of Communications. This legal framework, details the procedures for segmenting the existing railroad system by region, as well as the sale mechanisms for the public bidding for such segments. It also sets the rules for national and foreign investment participation in the sector. It is important to mention that foreign investment in railroads is restricted to forty-nine percent ownership.

The experience in the privatization of railroads has can be summed up in three problems: few bidders, valuation problems and rights of way problems. The first competitive bidding process was that of the Chihuahua-Pacific Railroad. This process was declared void by the authorities because the bid presented was lower than the minimum threshold required by the government. Since then, the Northwest Railroad and the Pacific North Railroad privatizations have been successful. Pending privatization are the Southwest Railroad and other short railroads.

B. Ports

The privatization process of ports has been almost entirely implemented. To complete this process, a new law providing for the creation of Mexican companies

\textsuperscript{14} Ley Reglamentaria del Servicio Ferroviario, D.O. 12 de Mayo de 1995; implemented by Reglamento del Servicio Ferroviario, D.O. 30 de septiembre de 1996.
denominated “Administraciones Portuarias Integrales” (“APIs”) was required.\(^{15}\) APIs have title to the concessions for the use and management of ports. APIs have been sold to the private sector through public bidding processes. Foreign investment is permitted up to a 100% in the port sector.

Between 1995 and 1996, auctions took place regarding several port terminals and installations specializing in cargo, in addition to three cruise-ship terminals and the port administrations of Acapulco and Puerto Vallarta.

C. Petrochemicals

The bidding process for the privatization of the secondary petrochemicals sector was expected to begin in October 1995. Foreign and national companies immediately expressed an interest. However, the government yielded to internal pressures, which affected the initial stage of the privatization process and delayed the implementation of privatization of sixty-one plants located within ten individual petrochemical complexes, fourteen storage terminals, and a maritime export facility in Pajaritos, Veracruz.

To date, the petrochemical complexes of Tula, Escolm, Cosoleacaque, Camargo, Morelos, la Cangrejera and Pajaritos have been privatized. Cosoleacaque and Cangrejera alone accounted for seventy percent of Pemex’s total production of petrochemical.

Some of the challenges these privatizations have faced include the difficulty in maintaining investor interest in face of union hostility to privatization, delays in the implementation and responsibility for environmental liabilities.

D. Airports

In preparation for the privatization of airports, modifications to the existing legal framework have taken place with the enactment of a new law.\(^{16}\) Mexico has eighty-three airports, of which, only seven are profit making entities. Concessions over airports will be granted through public bidding processes. It is expected that the first bids for concessions of groups of airport terminals will take place late 1997 or early 1998. Details of these privatizations have yet to be defined.

E. Satellites

The amendment of article 28 of the Mexican Constitution reclassified satellite communications to permit private investment. In February of 1995, privatization of the government owned monopoly began. Mexico has three satellites and twelve orbital positions. This system is used for private and commercial purposes mainly. Privatization of this system is underway, beginning with the adoption of a new legal framework to permit private investment in this area. A corporation denominated Satelites Mexicanos, S.A. de C.V. has been created for the privatization of the system, and is expected to be sold in a public bidding process before December 1997.

\(^{15}\) See generally, Ley de Navegación, D.O., 4 de enero de 1994.
\(^{16}\) Ley de Aeropuertos, D.O. 22 de diciembre de 1995.
F. Other privatizations

This process of encouraging participation of private investment has not always resulted in positive economic results for the government. One example is the highways, which have required subsidies that amounted in 1995 to approximately 1% of GDP, and to almost 3% of GDP during 1996. The government announced on August 22, 1997 a US$7 billion dollar bail out to developers of highways. Among the causes that led to this economic situation were: (i) the ambition of the past administration to build as many kilometers of highways, as those that had been constructed in the last twenty-five years - thus fifty-two concessions were granted; (ii) demand was inaccurately estimated; and (iii) interest rates soared after the 1994 crisis.

VI. CONCLUSIONS AND PROPOSALS FOR REFORM

Although the economic reforms of the past decade have changed Mexico profoundly, the country's economy still remains highly fragile and vulnerable to external shocks, as the 1994 currency crisis demonstrated. The following are proposals offered to assist in improving the stability and effectiveness of the Mexican economy.

i.) It is important to get the macroeconomic environment right before launching any major privatization sales. Mexico did this adequately during the first round of privatizations. In the present administration, stabilization of the economy has been essential to improving the conditions for privatizations. It is difficult to complete a privatization program successfully in a context of debt overhang and macroeconomic fragility.

ii.) Improve data on the basis of which perceptions of country risk are made. Recent developments in the Mexican economy have significantly improved the perception of the economic prospects for Mexico.

iii.) Provide "certainty" about the regulatory situation. This includes obtaining certainty about the nature and quality of the regulator, the duration of the concession, and the conditions that the privatized entity will need to fulfill as well as service levels and quality for infrastructure investments. For example, Mexico permitted Telmex to maintain its monopoly license for a period totaling no more than seven years after its sell off.

iv.) Improve economic forecasting in the development of the Mexican economy, thereby watching carefully international price benchmarking.

v) Make room for a strategic operator. In the case of Telmex, two categories of shares were created to enable control with a small block of shares.

vi) Eliminate cross subsidies, by providing interim subsidies if necessary. In addition, charge real prices for services.

vii) Do not link privatization to any complex, ill-defined social objectives such as "cleaning up the environment" or "protecting employment." These programs usually serve as excuses to lower the price.

viii) Screen potential bidders thoroughly before opening bids. Then always choose the highest bid. It is critical that this be a sequential process.

17. Geri Smith, Mexico’s Congress Turns From Lamb Into Lion, Bus. Wk. 58 (September 22, 1997).
ix) Allow time and flexibility to correct inappropriate cost structures. Telmex had an excess of 7,000 operators when privatized.

x) Improve identification of those cases with less strategic importance.

xi) Sell “as is” whenever possible. Trying to restructure is a waste of time and money.

xii) Use the capital markets of developed economies for large transactions.

xiii.) Ensure participation of the Federal Antitrust Commission (“CFC”). It has considerable power in Mexico and is a key player in most privatizations. The CFC may be used effectively to regulate monopolies in order to encourage competition. It is necessary for bidders to obtain the CFC’s approval prior to a privatization.

Finally, as mentioned before, perhaps the most important lesson is that privatizations are situation specific. That is, each privatization poses a unique set of problems and challenges.