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A STEP IN THE RIGHT DIRECTION? PRIVITIZATION OF NATURAL GAS SERVICES IN MEXICO AND AN EXAMINATION OF THE BURGEONING ROLE OF LOCAL DISTRIBUTION COMPANIES

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I. INTRODUCTION

Mexico is one of the first countries in the world that has privatized mid-stream services without first privatizing up-stream and down-stream natural gas services. Gas production, however, remains a monopoly of the state through PEMEX and CMP. Most of the important users of natural gas in Mexico remain monopolized particularly the electric power industry and petro chemicals. Beginning in 1995, Mexico has been successful in privatizing natural gas in the areas of its transportation, distribution, marketing and storage.

In the 1990s, Mexico began to explore the benefits of privatization in the realms of electrical power, oil and natural gas. In 1992, Mexico attempted to quasi-privatize the electric power industry with little success. In 1995, however, Mexico basically changed its infamous mentality regarding subsoil properties. On April 29, 1995, Article 27 was amended by the Mexican Congress permitting the private ownership of pipelines for the transmission and distribution of gas. Mexico’s natural gas has been unknown for years except for a few areas in the north like Monterey, Cananea, and Mexicali. The Mexican government now appears to understand that natural gas is a very important and beneficial fossil fuel. Specifically, natural gas is environmentally friendly, readily available, cheaper than propane and cheaper than LP gas.

II. RECONSIDERING THE PRIVATIZATION OF NATURAL GAS AND ITS IMPACT ON NATIONAL AND FOREIGN COMPANIES

The Mexican government privatized in an effort to allow private foreign and national participation in the transportation, distribution, marketing and storage of natural gas. A two-prong approach was developed for launching the privatization process. The Mexican government began by enacting clean air laws establishing environmental norms calling for the consumption of low sulfur fossil fuels. As of 1998, all of the end users burning fossil fuels were compelled to use fossil fuels with low sulfur and in many instances such fuel has been natural gas.

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2. Petroleos Mexicanos (PEMEX) Mexican Petroleum was formed in 1938 as a state enterprise charged with operating expropriated subsoil properties.
The first thing that the Mexican government did which has been a success, was to encourage Local Distribution Companies (LDCs) to gasify a predetermined geographic zone. By choosing to gasify such geographic zones, LDCs have encountered a substantial risk requiring substantial investment and risk. Consequently, LDCs cannot be the only parties charged with the exclusive right to conduct and distribute gas.

The first cities to be classified as a particularized geographic zone for LDC purposes have been Mexicali, Chihuahua, and Mexico City. Since the inception of the geographic zone scheme, about twelve cities have been awarded to companies based in the United States, Canada and Europe. Companies that have been awarded zones through the bidding process are Sempra and Lonestar, both companies based in the United States. These companies have had experience in operating as distribution systems. Awarding geographic zones to foreign-based companies has occurred for obvious reasons. The Energy Regulatory Commission (CRE) requires a showing of time tested experience and financial clout. Winning the public bid process is highly competitive; thus, the company that offers the largest coverage of end users by the fifth year of operations of the system is in a superior position.

Only a few Mexican companies have been able to effectively participate due in part to the past history involving the formation of Mexican monopolies. Hence, a finite number of Mexican companies have actual experience in transporting and distributing gas. Gas has traditionally been run by PEMEX gas and Petrochemical, one of the PEMEX operating subsidiaries. A limited number of Mexican companies will have the capability to run a LDC system. Some Mexican companies in Monterey, Cananea, and Cuidad Juarez appear to have the operating and logistical capability of continuing to operate their own LDCs.

The LDCs are subject to post a letter of credit for $10 million dollars. If the number of end-users are not connected, as promised, the letter of credit will be drawn upon by the fifth year of operation. Thus, all of these companies are compelled to market and promote the use of natural gas, which in Mexico is not common. For example, as of yet, Guanajuato does not have a LDC. If Gas DeFrance or any other reputable gas distribution companies ask for a LDC bid to be established in Guanajuato and they win, then the company would have to break the streets, provide all of the distribution systems and satisfy the number of end-users with the rates promised. The necessary changes to infrastructure within areas that have not yet been gasified are clearly substantial and pose an onerous burden on any company be it national or foreign-based.

Distribution is inherently different from transportation. For example, transportation involves the transport of natural gas from one production zone to a LDC zone. Additionally, transportation is not subject to international rules instead it is just a matter of obtaining a permit. These transportation companies are required to build a transportation system whereby the LDC can distribute gas within the zone. Transportation companies do not have exclusivity nor do they have any sort of benefit of exclusivity with regard to the route. Thus, transportation companies are not required to engage in a comprehensive gasification process.

4. The CRE is the federal agency in charge of enforcing natural gas regulations and electricity regulations.
Essentially, transportation companies do not have any sort of obligation to the number of end-users and if they fail, no letter of credit will be collected. The only risk encountered by transportation companies is the need to establish a link to the market. The LDC is the one that aggregates the loss and is the one that has the client. Transportation companies are challenged in the sense that they must build a transportation system for the first time.

To build the transportation line, it is necessary to obtain close to 250 governmental permits from federal, state, and municipal permits. Foreign companies will encounter an arduous task in establishing the necessary infrastructure for building the transportation system. This presents a new dimension for Mexican practices since all of the right of way experience has been accumulated by public companies.

There are two types of transportation permit classifications: 1) open access permit and 2) self-use permit. The open access permit is very much like a utility. Such permits are necessary for providing services on an open access basis, on a non-discriminatory basis. They are subject to maximum regulated rates negotiated every five years and are subject to heavy scrutiny by the CRE. The problem in transportation currently faced, and that will be encountered if the privatization of electricity ever becomes a reality, is that the transportation companies will have to compete with PEMEX. PEMEX continues to operate approximately 12,000 kilometers of pipeline, essentially transportation lines. Therefore, if a company wants to compete with PEMEX, the problem that it will have is that it will need to have a strong critical mass of clients, good anchor clients, and good marketing arms in order to displace the contracts or displace the end users that PEMEX has serviced for years.

One of the problems that will continue to loom is the reality that PEMEX remains the country's sole producer of gas, the largest transporter of gas and the largest marketer of gas in Mexico. PEMEX gas and Petrochemicals continue to conduct the supply, the transportation and the marketing of gas in Mexico regardless of recent legislative and constitutional reforms.

Transportation companies have a difficult task to compete with PEMEX's transportation capabilities, something which LDCs have avoided in the realm of distribution. In distribution, the Mexican government asked PEMEX to spin off all of their LDC assets. Privatization has occurred with regard to LDCs as PEMEX responded by selling the assets as requested by the Mexican government. Transportation remains subject to the monopoly of the state, however, to a certain extent the potential for private competition in the market remains viable.

One of the positive signs occurring recently is that within the Mexican government, the Ministry of Energy has eliminated the four percent (4%) import duty on natural gas from the U.S. Previously under NAFTA, a ten percent (10%) phase out importation duty was imposed on natural gas. This importation duty was going to be fully phased out by year 2003. The Mexican government decided to unilaterally eliminate the four percent of the duty in 1999 and now it is zero. Mexico wants to bring competition over to the relevant market. Essentially, marketers will be able to market their gas to all of these big end users.

The largest power plants currently being built in Mexico will require massive loads of gas. The 4% import duty is no longer enforced so PEMEX will have to compete like any other marketer. The obvious problem is that if a company wishes
to market gas, it will need a pipeline. At this point, PEMEX operates the limited number of pipelines in Mexico. This distribution is one critical point of consideration when representing transportation companies trying to compete with PEMEX, is very much like the situation encountered during the privatization process of Mexico’s telecommunications system and Telmex. Here, the recent ruling prohibiting PEMEX from becoming a marketer from the CRE was significant. Such agency action is a positive sign evincing the government’s commitment to increasing competition. The CRE is demonstrating its plan to try and enforce some kind of an affiliate market rule so more competition will exist between transportation and marketing companies.

Privatization of the gas industry is becoming a reality. Foreign investors have pledged a significant amount of investment. Unfortunately, Mexican companies may not be able to participate on account of a lack of knowledge, essentially, the know how to effectively compete. That is very much the price of having a monopoly for 60 years. If a country has a single company operating the gas industry, and then the country later wants to privatize, only experienced companies will be competitive. With regards to Mexico, the majority of companies showing such time-tested experience are foreign-based companies. The twelve LDCs conferred have been awarded to foreign companies, except for a few Mexican companies that were originally grandfathered in the north part of Mexico.

With regards to electricity, the Mexican government has asked the Federal Commission of Electricity (CFE) to engage in a conversion from other fossil fuels like fuel oil and propane to gas. Most power plants are required to begin burning gas. Additionally, due to current environmental norms, most power plants will be gas driven plants of which many will be fueled by private companies. The way that the Mexican government is trying to promote private participation in the realm of electricity is through gas. Mexico is trying to promote first co-generation and self-supply which is basically a consumption group of end users. The CFE is also launching a program of Independent Power Producers (IPPs). The independent power producer basically means that a private developer, a privately held company, generates electricity and all of the capacity and associated power output is sold in bulk to CFE. It is important to note that the IPP program is subject to international public bid rules. The developer is now afforded great flexibility, thereby allowing developers to aggregate loads. In other words, developers are allowed to submit proposals for oversized plants during the bidding process and upon being awarded the bid developers are enabled to offer lower rates. The first developer to adopt such an approach in the bidding process was Intergin. Intergin took the risky step of submitting a 645 megawatt plant offer. This was a bold approach considering that the CFE was asking for 450 MW offer. Intergin essentially indicated that it would build it a 645 MW plant and the excess capacity would be sold to other takers. This was another important step taken by the government thus allowing increased private participation. The next developer to submit a proposal for an oversized plant was Hiberdrola in Monterey. The CFE was asking for 495 MW plant while Hiberdrola offered to build a 740 MW plant.

Upon securing bids for oversized plants, such companies need to establish a client base in order to guarantee that the excess capacity produced by the plant will be utilized. The government is also trying to make changes in the transmission and distribution of electricity through legislative change regarding the electricity law.
Now what the government is trying to do is make changes regarding regulations of the electricity law to make the system work in a more efficient manner. Currently, it is very difficult to make a co-generation plant the way that the legal framework is enforced. In the event that success in this Congressional session is not forthcoming, changes to the regulations may occur which do not require Congressional action. Regulatory modifications only require administrative action.

The Mexican government is facing substantial difficulties with regard to its plans for privatization. This is particularly true in a government that is operating with the smallest budget in the last twenty-five years. The primary problem facing Mexico is that 167 power plants and miles and miles of transmission lines will need to be privatized in the near future. For the foreseeable future, this will persist as a most sensitive issue.