

Mexico City, Federal District, on December 19<sup>th</sup>, 2013

## **The Constitutional Amendment in the Energy Sector: The Future of Mexico's Electricity Sector**

***Executive Summary:** The Federal Government's constitutional amendment proposal in the energy sector has been upheld constitutional by the Permanent Commission of the Mexican Congress and will be enacted by President Enrique Peña Nieto on December 20<sup>th</sup>, 2013. The amendment, will allow the private sector to become involved in the generation and commercialization of electricity to individuals, except of nuclear technology. Electrical transmission and distribution will yet be handled by the Federal Commission of Electricity (CFE) as governing authority, whom will however be able to execute contracts with individuals or entities relating to these matters but will not be able to grant concessions.*

*The approval of the constitutional amendment and the subsequent publication of the secondary laws will cause a profound restructuring of Mexico's electricity sector. The constitutional amendment will provide the necessary foundations for the further modernization of power plants, through the use of more efficient and ecological technologies, as well as the improvement of the transmission and distribution infrastructure, thus, providing companies in the field with an array of new opportunities and will boost the economic development of the country achieving a larger incorporation of users to the supply of electric energy.*

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## **I. Introduction**

On December 11<sup>th</sup>, 2013, the Mexican Congress approved the constitutional amendment in the energy sector (the "Amendment"). Once approved by the Mexican Congress, the bill was sent to the legislatures of the Mexican States, where more than 17 state legislatures endorsed the Amendment and therefore, it has been upheld constitutional by the Permanent Commission of the Mexican Congress and will be enacted by President Enrique Peña Nieto on December 20<sup>th</sup>, 2013.

The Amendment, which modifies articles 25, 27 and 28 of the Mexican Constitution will bring a profound restructuring in the Mexican energy sector by allowing the entrance of private investment in such sector. The following information will explain the legal framework that currently regulates Mexico's electricity sector, the Decree Project's content, the possible impact on private companies involved in the sector and the new business opportunities that may arise with the publication of the Amendment and its secondary laws.

## **II. The current legal framework in the Mexican electricity sector**

The electricity sector in Mexico faces major challenges. The price of electricity is high and is not competitive. This is hampering the Mexican economy since electricity is an essential input for industrial, commercial and services activities.

Currently, the generation, transmission and distribution of electricity to the public, is a service which can only be provided by the Mexican State, specifically by the public sector agency known as Federal Electricity Commission ("CFE"). The involvement of the private sector in the electricity field is allowed exclusively under certain legal forms and generation schemes which legally do not fall under the category of "public service".

The most important of these generation schemes are those of "Independent Energy Producers" ("PIEs") and "Self-Supply" partnerships. PIEs implicate that output is exclusively sold to CFE and these transactions arise from purchase contracts awarded through a public tender. Since CFE is legally obliged to purchase

power provided at the lowest available costs<sup>1</sup>, the awarding of PIE projects based on renewable technologies (in this case, wind technologies) have been rare.

On the other hand, Self-Supply partnerships allows for independent producers to generate electricity to supply their own power necessities and also those of its partners. Under this scheme, a Self-Supply partnership is created between an investing/developer partner and at least two consumer partners. The law does not require that the consumer partners be provided with an amount of electricity that is proportional to their shares in the partnership; rather, the power provided to each consumer partner is the result of a power purchase agreement with terms that are agreed between the generator and the consumer partner. Recently, photovoltaic developers have been also exploring the "Small-Scale Producer" ("SSP") scheme. Under the SSP, only projects with a maximum capacity of 30 MW qualifies and sales are exclusively made to CFE and the corresponding consideration to the SSP is based upon the Total Short Term Costs ("TSTC", CFE's production costs) proportion.

The private sector's involvement in the generation of electricity is significant<sup>2</sup> and the private generation scheme of Self-Supply has caused renewable energies to become an increasingly prominent source for electrical output<sup>3</sup>. The expansion of renewable energy sources in the Mexico's energy matrix has, nevertheless, been limited due to a deficient transmission infrastructure. Moreover, regulatory restrictions that apply to generators under the Self-Supply scheme have made the financing of projects more complicated and expensive. CFE's production costs are high, especially industry fees when compared to the fees offered in other

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<sup>1</sup> Article 36 of the Electric Power and Public Service Act.

<sup>2</sup> By the end of 2011, 29.1% of the gross production of electricity came from PIEs, 4.9% from Self-Supply partnerships and 4.3% from cogeneration. Source: "Prospectiva del sector Eléctrico 2012-2026", PDF document published by the Ministry of Energy and available in the following URL: [http://www.aiest.unam.mx/biblio/PSE\\_2012\\_2026.pdf](http://www.aiest.unam.mx/biblio/PSE_2012_2026.pdf).

<sup>3</sup> Of the 259 TWh of gross electricity output allocated to public service purposes in 2011, 16.34% (42.35 TWh) was provided by renewable energy sources. In total, the following are the statistics for the provision of electricity with renewable sources by the end of 2011: 13.8% hydraulic, 0.04% wind energy, and 2.5% geothermic. Source: see the footnote above, p. 92.

countries and this is a factor which affects national competitiveness<sup>4</sup>, while Mexico subsidizes power supply fees for the residential and agricultural sector<sup>5</sup>.

### III. The energy amendment for the Mexican electricity sector

The Amendment proposes that a profound restructuring of the electric market be effected in order to enhance the possibilities for more private investment in the electricity generation sector. Nevertheless, electricity transmission and distribution will remain as services that are exclusively provided by the Mexican State (specifically, by CFE). Nonetheless, the possibility of executing contracts with individuals and entities concerning particular aspects of transmission and distribution services have been included in the Amendment. CFE, along with PEMEX, will move from decentralized agencies to "productive state enterprises", with technical, management and budget independence. Their purpose shall be to create economic value and increase national income, with a purport of fairness, social and environmental responsibility. Its operation will be based on effectiveness, efficiency, honesty, transparency and productivity criteria based on the best practices in their respective fields. While its regime change, CFE will be able to enter into agreements under the new legal framework.

Even though private involvement in the electricity sector was allowed, important and large scale projects were subjected to the planning and organization of CFE and limited by the Mexican budget. This has become a bottleneck that prevents high-speed development of potential sources that could produce electricity at lower costs.

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<sup>4</sup> In 1998, Mexico's electricity supply fees were 10% higher than the average fees offered in OECD countries; by 2013, this difference has increased to 44%. Source: "Luz a la competitividad nacional: propuesta de reforma al sector eléctrico en México", document published by CIDAC on August 19<sup>th</sup> 2013: p. 8.

<sup>5</sup> By 2011, the total amount of the residential sector's subsidy to electrical supply fees amounted to 38,902 million pesos while that to the agricultural sector amounted to 6,768 million pesos. Source: "Tarifas: relación precio-costo de energía eléctrica por sector de consumo", online document published by CFE. Available in the following URL: <http://www.cfe.gob.mx/SiteAssets/Lists/Preguntasfrecuentes/NewForm/Anexo%20estad%C3%ADstico%20quinto%20informe%20de%20gobierno.pdf>.

Additionally, the Amendment provides the necessary structural strengthening of CFE through greater operational and organizational flexibility, which will help improve and increase competition, cut costs and therefore cease to be an electrical company to start being an energy company that can compete globally. Moreover, the planning powers of the Mexican Ministry of Energy ("SENER") and the Energy Regulatory Commission ("CRE") have been strengthened. Therefore, the SENER shall establish the terms of strict legal separation in the electricity required for the promotion of open access and efficient operation in the sector, meaning that the separation and vertical disintegration of generation, transmission, distribution and commercialization activities will fall under SENER's authority and not the regulator, the CRE; the Mexican Congress will set the regulatory framework in which CRE will operate.

1. Generation of Electricity by private producers

The Amendment does not provide for CFE's privatization but rather seeks to make Mexico's electricity field more accessible to private investment, meaning, Mexico will maintain the exclusive control of the National Electric System, which shall be operated by the correspondent agency. The main goal is for private enterprises to generate electricity and sell it freely in the market to third parties by the lifting of any previous constitutional restrictions that made "public service" supply and sales exclusively reserved to the Mexican State. Likewise, private enterprises will be able to operate the transmission and distribution networks to sell the energy that they produce. Thus, the previous legal modalities included in the Electric Power and Public Service Law that regulated electricity generation by non-state entities will then become obsolete, allowing private sector participation in the public service generation. Likewise, the Amendment removes the terms "generate", "conduct", "transform" and "supply" electric energy, as exclusive powers of the Mexican State.

2. The Public Service Transmission and Distribution of Electric Power

Mexico, through CFE, will still be in charge of the transmission and distribution of electricity for public service purposes. Nevertheless, and even though the Amendment prohibits the awarding of concessions of transmission and distribution services, the possibility of "executing agreements with the private sector according to the terms set forth in the laws," will exist in the electricity field. It will be necessary to analyze the correspondent secondary laws to see how

these agreements will be regulated, as well as their structure, terms and conditions.

Notwithstanding the above, the Decree Project in its transitory dispositions establishes the obligation of the Mexican Congress to execute, within the 120 natural days following the enforceability of the Amendment, the modifications of the legal scenery in order to set forth the regulatory framework applicable to the specific agreement schemes for the private sector to execute, among others, the financing, the installation, maintenance, management, operation and improvement of the necessary infrastructure to provide the public service of distribution and transmission of electricity.

### 3. The National Center for Energy Control

No later than 12 months after the enforceability date of the electricity industry regulations, the President must issue the Decree whereby the National Center for Energy Control is created as a public decentralized agency (it is currently part of CFE), who shall be a third impartial party in the form of an arbitrator who shall be responsible for the operational control of the National Electric system, operating the wholesale electricity market, as well as the open and not unduly discriminatory access to transmission and distribution networks. CFE shall transfer the material and human resources to the Center for the operation of the system and it shall be independent. The National Energy Control Center will provide CFE the necessary support for up to 12 months after its creation, to continue operating its public service transmission and distribution networks.

#### **IV. The impact of the amendment to Mexico's electricity sector, renewable energies and development of Mexico**

The Amendment provides a constitutional basis for the restructuring of Mexico's electricity sector by means of the constitutional modification of certain historic dispositions. The impact that the Amendment will have on enterprises in the electricity sector will thus depend on the secondary laws and its correct implementation and applicability. In connection with this issue, the Amendment does not provides details and specifics but rather sets forth certain goals and objectives; however, it is vague as to the means with which these goals are going to be accomplished. With the Amendment, the Federal Government seeks to reduce the electricity supply fees and the substitution of electric power plants which use highly polluting and less efficient technologies to more efficient and zero-polluting electric power plants (or less polluting ones) for which it is necessary to increase the meshing of the transmission network and interconnect the areas of the country with high potential for clean energy. Likewise, it is required to include private generation projects and remove barriers to the development of wind projects and solar technologies. The Amendment also mentions the enhancement of electricity production based on natural gas and clean energies, through the introduction of the concept of "sustainability" in article 25 of the Mexican Constitution with the purpose of including the environment care in the economic development of the country.

Current PIEs which can sell their generated electricity exclusively to CFE will be able to expand their facilities as well and also sell their generated power to different consumers. Self-Supply partnerships will also be able to sell their produced electricity to other consumers without them having to become consumer partners in the partnership. This increased flexibility regarding the consumer basis of private producers will have a positive effect on the financing conditions for future projects. Simultaneously, the Amendment will allow enhanced development of electrical transmission and distribution infrastructure and will also assure its access and usage under the same conditions and in a complete and non-discriminatory manner to all the producers of electricity. The Amendment will greatly benefit producers which implement clean technologies that lower production costs or are less polluting. From a legal standpoint, private projects for the operation and development of the electrical grid seem feasible in

the future, under the proposed regulatory framework.

On a practical level, the Amendment's potential positive impacts on the renewable energies sector consist mainly in removing the legal obstacles for new projects and to build more transmission lines. Likewise, the granting of clean preferential credits in the financial system will be available. The previous bases which allowed the development of renewable sources projects will change whilst the new rules of the game still remain unknown. Wind technologies have found its market in the Self-Supply partnerships and in the execution of Power Purchase Agreements ("PPAs") with industrial clients. On the other hand, solar technologies are still in start-up phases at a national level. Companies who specialize in this type of technology are seeking to operate under the schemes of Self-Supply or that of a SSP. The consumers of Self-Supply partnerships must sell power to CFE at high rates. In the SSP modality, the consideration is calculated upon a TCPC basis (Total Short Term Costs by CFE – Production Costs).

Renewable energy projects depend on the possibility to execute long-term PPA with considerations that are financially viable. Currently, renewable energy projects can compete in the market of conventional technologies due to the high fees of CFE to Self-Supply Corporations or because of the high production costs that are usually incurred by SSP's. The most important element of the project – the consideration – will be affected by the Amendment. It is expected that the private producers' supply fees will be lower in comparison to the actual fees of CFE but the concrete impact that the Amendment will have on CFE's production costs (TCPC) remains unknown. Concurrently, the Amendment will allow access to the market to conventional technologies with lower production costs than technologies based on renewable energies.

Notwithstanding the above, the Amendment does not clarify how private sector involvement in electricity generation based upon renewable energies will be guaranteed in the newly shaped market since their production costs are still higher than those which use conventional technologies, even more, it seems that the Amendment has forgotten the renewable energies. In spite of including the concept of "sustainability" in article 25 of the Mexican Constitution as referred above, the Amendment is mainly focused in the sectors that are dependent of gas and oil, meaning, the Amendment is not integral neither has been planned in

a long term context. Nonetheless, the National Strategy for Energy 2013-2027, issued by the Federal Government, confirms that the goal established by the General Law for Climatic Change, which entails that by 2024 at least 35% of the country's total electrical output will be obtained from clean energy sources (renewable and nuclear energies) will be accomplished.

One of the objectives of the Amendment will be that of correcting the present limitations of today's legal framework in order to increase the large-scale generation capacity of renewable energies through the creation of a competitive market. For this goal to be achieved, it will be necessary that electricity production through use of renewable technologies be incentivized in some way, through a direct and aggressive incentive or benefit (to the import of renewable energy equipment or incentives to the production) or to remove or reduce the subsidies to non-renewable energies. Likewise, renewable energies require a clear legal framework as well as concrete strategies to its development. It is crucial for the government to issue, as soon as possible, the new conditions regarding generation and how the government plans on attracting private capital in the renewable energies sector so that the energetic matrix sought for Mexico can be in fact, reached. Otherwise, the risk of a standstill in the investment in renewable energy projects – particularly photovoltaic projects –will be imminent.

It will be necessary to wait the 120 natural days established in the Decree in order to confirm the commitment of the Federal Government on whether the secondary laws will yield benefits or establish a clear regulatory framework for companies that generate their electricity from renewable energy sources, particularly regarding (i) the capability to transport and distribute clean energy from the point of generation to reduce losses and congestion in the networks; (ii) the increasing in the demand for renewable energy projects with competitive generation prices, and (iii) the establishment of mechanisms that will allow the funding of new projects at a lower cost for Mexico. However, we are confident that the secondary laws will bring significant benefits in this sector as the Federal Government has made emphasis in this issue within the objectives outlined in the National Development Plan 2013-2018.

Electric generation with nuclear technology will maintain its status as an activity exclusively reserved to the State (CFE). The Federal Government refers to the

National Strategy for Energy 2013-2027 which refers to nuclear energy as a viable option to reach the 35% non-fossil fuel generation goal by 2025. In this case, the construction of a nuclear power plant would be auctioned by CFE as an electrical generation project of this enterprise.

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