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# POSSIBLE PRIVATIZATION OF THE POWER INDUSTRY: A PANEL DISCUSSION

MODERATOR:

LIC. ABDON HERNANDEZ\*

PANELISTS:

JAMES DEMENT, ESQ.

LIC. RAMIRO VILLARREAL MORALES

MICHAEL L. OWEN, ESQ.

LIC. ROGELIO LOPEZ VELARDE

ABDON HERNANDEZ, MODERATOR:

At the time when the decision was made to discuss the topic of energy, electricity and the privatization, we had expected that the proposed Amendments to the Constitution would have been enacted before the conference. That did not happen and thus many are dubious about the prospects of enactment during the Zedillo administration. However, the National Action Party (PAN) met recently in San Francisco to work on a proposed Amendment to the Constitution and the outline of the new electricity law. Rather than calling it a process of "privatization", they are labeling it "liberalization". The name change may be a solution to the political problems because "privatization" touches certain emotional strings in some sectors of Mexico in terms of sovereignty.

As we have seen with mining law and foreign investment law, regulations pursuant to Article 89 of the Constitution and the regulatory power of the executive sometimes go beyond the law, which raises questions regarding their constitutionality.

MARIO CAMARA, AUDIENCE MEMBER:<sup>1</sup> Mr. DeMent, shouldn't the question be "when" the electric sector will be privatized, not "if it will be", and what the cost will be of doing it later rather than sooner?

JAMES DEMENT, PANELIST: Yes. Based on the statistics of the problems in the Mexican electrical sector: theft, loss of energy, lack of dependability, and the aging infrastructure, pretty soon the lights will go out, as occurred in Columbia and Ecuador. I hope that in Mexico it doesn't take that kind of reality to force hard political decisions. The Minister of Electricity is very far sighted to anticipate the problem and begin to solve it now.

There is a financial cost and a political cost to privatization and I believe that Mexico can reduce the financial cost if it does it now. I don't know what the political cost is. If you have got a public opinion poll that says 73% of the population are against it, and professors and populist politicians are exciting people who don't understand the international financial aspects involved, you may have to wait until you can solve the political problem. Of course, Mexico will pay more money to do it later rather than sooner. Furthermore, the very people who are opposed to the reforms will foot the bill. What do you think Mr. Villarreal?

RAMIRO VILLARREAL, PANELIST: I tend to agree with you. The privatization process will continue once these political issues have been solved. In fact, my company has a self-generation facility in Columbia because of the problems that

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\* A summary of the background of each of the participants in this panel follows on the last page of the discussion.

1. Mario Camara, attorney from México City.

Mr. Dement outlined. In Dominicana we just completed another one. Here in Mexico we are doing a twin plant project to meet the current requirements of our facilities. Unfortunately, the supply of energy is not as reliable as it should be for an industrial process. I think it is just a matter of time. Unfortunately, the political implications tend to delay things and, of course, that may represent a cost for the country.

**MICHAEL OWEN, PANELIST:** When Zedillo proposed privatization in February, the hope and expectation in many quarters was that it would be adopted quickly before the Congress adjourned for the summer and before the September session started. Of course, that did not happen. The feeling was that the September session would focus on the upcoming elections and therefore not adopt the proposal. If it was not adopted before September many believed that it would not be politically feasible for that to happen until after the election. The fear now is that none of the pre-candidates are strongly in favor of privatization, given their backgrounds.

**MIGUEL JÁUREGUÍ, AUDIENCE MEMBER:**<sup>2</sup> Vicente Fox, a politician seeking the PAN candidacy has gone as far as to talk about the privatization of PEMEX<sup>3</sup>, a step which would be far more controversial than the privatization or liberalization of electricity. I think the delay in this year's discussion, or the perceived delay, arises from this position of the PAN - PRD (Party of the Democratic Revolution) alliance. Due to the discussions of establishing a political alliance in Mexico between the PRD and the PAN, the PAN really was not able to move forward during the first half of 1999. In a recent declaration, the new PRD president, Amalia García, said that the alliance between the two parties in 2000 depends on the extent to which the PAN would be willing to abandon some of its positions and political platforms. This creates the perception that we won't have this liberalization/privatization this year. If the alliance collapses, the PAN will return to the rank and file and vote with those PRI members who are in favor of liberalization. If this happens, privatization may happen during President Zedillo's administration. This would make it much easier to attract capital into Mexico and to jump start the incoming President. Both the PAN and the PRI know that. I think the second step of the thought process is how to make this a virtuous process and thus make Mexico a much more modern place to manufacture and globalize.

**JAMES DEMENT, PANELIST:** What I observe of Mexican politics is that they are able to call a sheep a goat or a goat a sheep and that makes all the difference in the world. I wonder if calling this liberalization, instead of privatization, isn't the way out of the conundrum. It seems to me that the whole emotional discussion about the privatization issue of electricity makes it sound like PEMEX,<sup>4</sup> though it is actually more like TELMEX.<sup>5</sup> If the politicians can get together and say, look, electricity is not the national patrimony, it's a business. It's like the telephone company and I think the telephones have worked better since the privatization. Or

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2. Miguel Jáureguí, Founding partner of Jáureguí, Navarette, Nader, Rojas, Mexico, D.F.

3. PEMEX Petróleos Mexicanos. The Mexican state held petroleum monopoly created from the foreign owned oil companies expropriated and nationalized in 1938 by President Lazaro Cardenas.

4. See footnote 8.

5. *Teléfonos de México* (TELMEX) Mexican national telephone company, partially privatized with 49% ownership in ITT and 51% with Mexican private investors.

it could be thought of as being like the railroads<sup>6</sup>. Perhaps that's one more way to call a goat a sheep and then be able to vote for it.

AUDIENCE MEMBER: Another important factor is the division between the two Mexican producers. The *Comisión Federal de Electricidad* (CFE)<sup>7</sup> generates 95% of Mexico's necessities, and *Compañía de Luz y Fuerza del Centro* (CLFC)<sup>8</sup>, generates 5%. However, the CLFC has the largest number of employees and is controlled by a different union. The CFE's union is in favor of privatization, while the CLFC's union is against it. The reason the CLFC is against privatization is that they will lose their privileges, and they know that if their operation is modernized they will lose jobs. So, as their support is necessary, proper attention should be paid to their concerns and any privatization should include a change in the CLFC structure that assures the employees either a proper pension or retirement and perhaps even ownership of the company so they can make their own adjustments pursuant to the market.

MICHAEL OWEN, PANELIST: The privatization/liberalization language issue is only one aspect of the whole proposal. I think we should be careful in just talking about a solution in terms of a change of name because there may be a basis here for real substantive change.

The proposed privatization of the generation facilities by CFE has caused considerable concern in one quarter that has not been mentioned yet today and is rarely mentioned in the Mexican press: namely, the lenders who financed industrial power plant (IPP) projects and other projects to finance generation in Mexico. When this proposal came out there was considerable consternation among many of these lenders, especially the export-import banks around the world who are some of the major financiers of these IPP projects. They lent on the basis of sovereign risk<sup>9</sup> and now are facing privatization. In fact, if you look at the publication by the Mexican Secretary of Energy, it is very clear that that is what they intend to do and doesn't acknowledge that there is one other party that has to agree to this: the lenders who provided the financing. There is a real problem here that the government is aware of, and there may be a need to temper the existing proposal with the respect to privatization. This, perhaps, gives more meaning to the use of the term "liberalization."

ABDON HERNANDEZ, MODERATOR: The company that I work with has an electrolytic zinc refinery facility in northern Mexico that consumes in one day as much electricity as the whole city of Veracruz. We have an agreement with the CFE which allows seven interruptions to the supply of electricity a year. As of June 30, 1999 we already had five interruptions due to insufficient electricity to meet the demand of Northern Central Mexico. Hence, although people think that the brown-outs we have seen in Mexico City are intentional to force down their throats the

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6. The Mexican national railroads have been partially privatized by selling off portions of the lines and rights to operate them.

7. *Comisión Federal de Electricidad* (CFE) Federal Electric Comisión

8. *Compañía de Luz y Fuerza del Centro* (CLFC) Power and Light Company of the Center. The CLFC serves only Mexico City and the surrounding areas.

9. Sovereign Risk is the concept that the loan is made to and backed by a sovereign who will be able to pay. Default by a sovereign negatively affects their ability to obtain financing from the export-import banks of the world as well as receive aid from the government of the creditor. Therefore, loans to sovereigns are considered much safer than those to private borrowers.

concept of privatization, the fact is that the brown-outs are real and due to a lack of electricity. People are also concerned because they feel that if electricity is privatized, the same thing will occur as that which happened with TELMEX: the rates will go up. This fear of rate hikes is one of the reasons why people feel strongly against privatization. However, if there is true competition and power generation becomes a major business endeavor, the major consumers will have direct agreements with the major producers and there will be more electricity for the people. It is possible that the rates will not go up. So perhaps it is a question of lack of information by the public.

Touching also on the loss of privileges, every retired employee of the CLFC's union, receives free electricity for life once they retire. That is something that Mexican public is subsidizing.

JAMES DEMENT, PANELIST: The subsidies in Mexico are \$2.2 billion and I don't think that all goes to the Union. I think there will be some political price to pay for the phase out of the subsidies.

RICK CUMMINGS, AUDIENCE MEMBER:<sup>10</sup> Do the proposed changes to the Constitution to allow privatization require a public referendum? Are there any other constituents that would have a say in the changes? There was mention of other laws that would need to be amended. Would they be amended as part and parcel of the general reforms or would there have to be another undertaking and a process of convincing the public regarding such further reforms?

ROGELIO LOPEZ VELARDE, PANELIST: In Mexico a Constitutional amendment requires two thirds of the Chamber of Deputies and the Senate to approve the revised bill. I say revised bill because I imagine that they will make a lot of changes. Then, a simple majority of the 31 local legislatures plus the local legislature for Mexico City will have to approve it as well. That is only to change one paragraph. The reform would change one paragraph and eliminate another one in Article 28, thereby leaving the transmission, dispatch and the operation of the electric system in Mexico as a Constitutional monopoly. The generation, distribution and marketing of electricity will be in the stream of commerce, i.e., they will be subject to participation from the public or the private sector. The problem will be the implementation and the enabling legislation requiring Congressional action. This will be difficult because it encompasses regulating all of the concessions, all of the distribution permits and then enacting regulations to govern the dispatch operation to be run by the *Centro de Operación del Sistema Eléctrico Nacional* (COSEN)<sup>11</sup> and the *Red Eléctrica Nacional* (REN)<sup>12</sup>. That is a tremendous job that may take two or three years. This is what is involved in changing one single paragraph, although it is obviously a very important and historic paragraph. If the bill passes this year, then what will be of the greatest importance will be the implementing legislation for the next administration.

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10. Rick Cummings, Esq. Mayer, Brown & Platt.\*\*\*

11. *Centro de Operación del Sistema Eléctrico Nacional* (COSEN) National Electrical System Operating Center

12. *Red Eléctrica Nacional* (REN) National Electrical Network

JOHN STEPHENSON, AUDIENCE MEMBER:<sup>13</sup> Licenciado Lopez Velarde, would you discuss the gas contract supply arrangements that have to be entered into with the IPPs and give us an overview of who supplies the gas as well as the structural aspects of gas supply contracts?

ROGELIO LOPEZ VELARDE, PANELIST: The supplies are an issue in Mexico because the only supplier to date is PEMEX (Petroleos Mexicanos), which has a monopoly. As of June 17, 1999, Mexico eliminated the 4% import duty, making it possible to have a foreign supply of gas along the border. The benefit from foreign supply, of course, will be to the end users located at the border. Those who are in the interior will not have the benefits of foreign supply because the pipeline infrastructure has not yet been built. So you are dealing with a single monopoly, PEMEX.

The *Comisión Reguladora de Energía* (CRE)<sup>14</sup> has published the General Terms of Service (GTS), which attempt to regulate PEMEX activities as a marketer and as a supplier. Regulations issued pursuant to the GTS, such as the First Hand Sales Directive, are in the process of being formulated. The CRE was to issue regulations regulating how to contract gas, how to allocate the available gas, who should have preference for the gas, long term agreements, one day agreements, firm contracts; through a directive which was to be published three months ago, as well as through a GTS, which must be published in the Federal Register and be approved by the CRE. The CRE asked for comments on the draft from all of the players. Because all of the players opposed the draft regulations, the CRE decided not to publish it.

The primary object of the directive is to regulate the monopoly. Because the importation of gas is not subject to regulation, you can freely negotiate your contract any way you please. However, if you want to deal with PEMEX there are specific regulations that are in the process of being enacted. It has taken a great amount of effort by the CRE to carry out this process due to the inertia which has arisen out of nearly 60 years of monopoly.

PEMEX is of course trying to protect its monopoly and maintain the flexibility they used to have in supply contracts. The flexibility they prefer is the ability to contract whenever they want and not to have long term contracts. However, long term contracts are crucial for obtaining lending and therefore benefit PEMEX's competition. What PEMEX Gas is trying to do is protect their turf, their monopoly. What the CRE is doing, with difficulty because the CRE was created only six or seven years ago, is trying to control this 800 pound gorilla. Fortunately it is getting a lot of advice from prestigious companies in the U.S., Canada and Europe.

Right now the key issue is whether those supply contracts will be regulated in the way desired by the CRE. A second issue is whether PEMEX will ultimately be barred from participating in marketing and transportation. This is crucial because they commingle both services, are given preferential treatment, and therefore easily displace any competitor. The third issue is the price. The price of PEMEX gas is regulated through a liquid price market index. PEMEX is required to offer prices and make discounts subject to anti-trust rules against predatory pricing. Currently

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13. John Stephenson, Esq. of Jenkins & Gilchrist and on the board of directors of the US-Mexico Law Journal

14. *Comisión Reguladora de Energía* (CRE) Energy Regulatory Commission

the issue is whether PEMEX will finally accept the CRE's rules and, secondly, whether the government will make the wise decision to discontinue or prohibit PEMEX from undertaking marketing in the relevant market.

**JAMES DEMENT, PANELIST:** God in His wisdom, or Her wisdom as the case may be, put Mexico's gas in the South and her industry in the North. I think that it is no accident that you see these power plants going in along the border. There are three possible answers if PEMEX doesn't come into line. One, the gas will likely come from the United States. There is a great amount of gas available there to sell and it can come right across the border. Two, the CRE will work its magic, i.e., stop the feuding between the CFE and PEMEX. The third possible answer could come in the form of alternative fuels. You don't have to burn gas. You can burn petroleum coke or other fuels. I wonder if you know anything about alternative fuels being burned in Mexico.

**RAMIRO VILLARREAL, PANELIST:** Yes. As a matter of fact our company already has two facilities in operation for the use of waste fuels and we have also started to use waste fuels in cement kilns. This is a very convenient method of creating energy. We have also been converting our kilns to petroleum coke, wherever feasible. Of the two power plants that we are going to build, one of them is being constructed in conjunction with Peñoles, who will use petroleum coke. We have signed, contrary to what Mr. Lopez Velarde was saying, very flexible agreements with PEMEX on petroleum coke. This is due to the fact that PEMEX had no other way to dispose of it. Therefore, they had to be very flexible with us. Our long term agreement establishes that petroleum coke will come from various refineries, which ensures a supply for the energy plants and some for the cement kilns.

**ROGELIO LOPEZ VELARDE, PANELIST:** I did not link gas production with gas supply. The situation has changed now with the possibility of freely importing gas and thus U.S. marketing companies are competing with PEMEX in this area. PEMEX knows that and they have to expedite the upstream problem; they have to increase production. In order to be more competitive they have to increase production.

**ERIK THUNBERG, AUDIENCE MEMBER:**<sup>15</sup> To what extent would the new law permit the importation of surplus energy or the installation of power plants in the United States for importation to the Mexican grid? Is that a possibility?

**ROGELIO LOPEZ VELARDE, PANELIST:** Yes, it is a possibility. The end user has to ask for an import permit. However, because all of the connection points are controlled by the CFE, the term deals are done by them, and thus they control all of the importation. But, yes, you could do it. There are seven or eight permits in the San Luis Rio Colorado, Sonora that are getting power from the State of Arizona.

**ERIK THUNBERG, AUDIENCE MEMBER:** To what extent would that be disadvantageous to Mexico in the sense that it wouldn't require any sort of investment in Mexico whatsoever, except for some transmission lines.

**ROGELIO LOPEZ VELARDE, PANELIST:** That is the key issue. Instead of building the infrastructure in Mexico, the power would simply be imported. Of course, there are a couple of imports that are being done by Sempra in Mexicali and

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15. Erik Thunberg, Co-Managing Editor for the United States - Mexico Law Journal, Albuquerque, N.M.

eventually they will be swapping operations because of the logistics of the border. But massive importation of power would be insane when you have eager companies in Mexico. All of the companies are willing to invest money to build power plants in Mexico and even export it instead of importing it.

ERIK THUNBERG, AUDIENCE MEMBER: That leads me to my third question. To what extent is Mexico contemplating connecting with the recently created Central American grid?

JAMES DEMENT, PANELIST: As Mexico does not have enough electricity for its own domestic needs, it will certainly not be exporting to Guatemala. As for the importation of electricity from the Central American grid, this will not occur for the same reasons that Mexico does not import significant amounts of electricity from the United States. There are two primary reasons that Mexico does not import from the United States. First, if Mexico were to import electricity from the United States there would then be two bureaucracies, the U.S. and the Mexican, involved in the process. One can only imagine the problems that would evolve out of such a set up. The second reason is that Mexico does not want to become dependent upon foreign sources for its electrical power, especially when such electricity will be much more expensive than a domestic power supply. Thus, while the importation of electricity is, in theory, an answer, it's the last answer. At this time it is not a very desirable nor a very feasible answer. It will happen; some electricity is already imported into Tijuana from San Diego. It is, however, only a stop gap, emergency measure and it is not good for long term infrastructure planning.

### BIOGRAPHICAL SUMMARIES

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Mr. DeMent is an Adjunct Professor at the University of Houston Law Center. He was a member of the Professional Editorial Review Board for *The International Lawyer*, 1987-1990. Mr. DeMent is a member of the Advisory Board, International and Comparative Law, Southwest Legal Foundation; Chairman, International Law Section, Texas State Bar, 1989-1990. He received his B.A. from Texas Christian University in 1969 and his J.D. from Cornell University in 1979. He was admitted to the New York State Bar in 1973 and the Texas State Bar in 1974.

Lic. Ramiro Villareal Morales is General Counsel for CEMEX, S.A., (Cementos Mexicanos). He earned his Licenciatura en Derechos with Honors (equivalent to a L.L.B. or J.D.) in 1967 from Nuevo Leon State University, Mexico. He later earned a Masters in Business Administration from Wisconsin State University. He has served as Counsel to many large corporations and commercial banks in Mexico.

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