

Mexico's Power Generation Sector: *Energy reform opponents challenge constitutionality of permits granted to private sector*

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Mexico's power generation sector is facing a possible crisis in the near future. The Federal Government has estimated that over 27,000 megawatts of additional power generation capacity will be needed by 2009 to avoid a power crisis in the country. Since 1960, the electricity sector has been reserved to the State. Private participation in generation activities is limited by law and the funds to increase the Country's generation capacity will have to come from the federal budget.

Despite several efforts to amend the Constitution to allow private participation in power generation activities, opposition from different political parties has prevented the initiatives from being discussed in Congress.

The highly politicized energy reform is not the only problem that the Fox's administration is currently facing to modernize the industry. Congressmen opposing any type of privatization of the energy industry filed a complaint with the "Auditoría Superior de la Federación" ("ASF") asking it to review the legality of the generation permits granted by the "Comisión Reguladora de Energía" ("CRE") to private parties. The ASF found that the generation permits granted by the CRE were illegal and contrary to the Constitution. The Energy Ministry filed a constitutional challenge before the Supreme Court alleging that the ASF does not have authority to decide on the legality of the generation permits granted to private parties by the CRE. The Supreme Court admitted the constitutional challenge and a final resolution is pending.

The Fox administration has been unable to obtain a consensus towards energy reforms, and now it is facing a legal battle to maintain the already damaged confidence of private investors.

Legal Framework of the Electricity Industry

The Mexican Constitution reserves to the state the generation, transmission, and distribution of electricity as a public service. The concept of "public service" means that only the State, through the state-owned "Comisión Federal de Electricidad" ("CFE") and "Luz y Fuerza del Centro" ("LyFC") may sell the electricity to the general public.

The law that regulates the electricity industry is the "Ley del Servicio Público de Energía Eléctrica" ("Electricity Law"), which allows for private participation in power generation activities, as long as such activities do not fall within the concept of "public service". Private parties may obtain a permit from the CRE to perform the following activities:

- Generation and cogeneration plants for self supply of electricity,
- Generation plants to sell the electricity to the state owned CFE,
- Generation plants for exports, and
- Facilities to import electricity for self supply purposes.

These permits are normally granted upon fulfillment of the technical requirements established in the Electricity Law.

Today, private generation activities amount to a total of 20% of the generation capacity in Mexico. In practice, these investments have lightened the burden of the Federal Government to use federal funds in this area. Nevertheless, the Federal Government would like to pass on this burden completely to private generation companies which are eager to invest in generation infrastructure in Mexico, but a Constitutional reform would be needed. Under the current political circumstances, it has not been an easy task for the Federal Government.

Current Situation of the Electricity Industry *Privatization Efforts*

In 1999, President Ernesto Zedillo announced that the federal government would have to spend over US\$59 billion in power generation infrastructure to meet the estimated demand for electricity by 2009. Zedillo realized that the investment needs were so great that the only logical solution would be to amend the Constitution to allow private participation and sell the state-owned assets. Unfortunately, this initiative was dismissed by Congress.

When President Vicente Fox took office in 2000, he announced that one of his priorities would be to modernize the energy sector through private investment. Despite several initiatives to reform the energy sector, no consensus has been reached. The issue has not been discussed by Congress yet and it is doubtful that it will be discussed during the remainder of this administration, since political parties will concentrate their efforts in populist activities towards the 2006 presidential elections.

Constitutional Challenge by Congress Against President Fox

In an effort to increase private participation in the power generation industry without the need to amend the Constitution, President Fox, in 2001, issued reforms to the regulations in the Electricity Law to increase the amount of excess power that private generators could sell to the state-owned utilities. A group of Congressmen filed a constitutional challenge before the Supreme Court, accusing Fox of exceeding his presidential authority. The Supreme Court, in an unprecedented decision, ruled that the amendments were unconstitutional. Moreover, the Supreme Court, in its discussions and deliberations, considered that power generation by private parties destined to the public service could be against the Constitution, without making a final ruling on this issue since it was not the subject matter of the case.

Legal Controversy

Review of Generation Permits Granted to Private Parties by the "Auditoría Superior de la Federación" ("ASF")

Last year, Congressmen Manuel Bartlett and Salvador Rocha filed a request to the ASF to review the procedures under which the CRE granted generation permits to private parties. The ASF is the House of Representatives' auditing entity, empowered to review the Government's use of the federal budget.

After a detailed review, the ASF determined that the generation permits, granted by the CRE to private parties from 1996 through 2002, were illegal and contrary to the Constitution. The ASF not only reviewed the use of federal funds by the CRE, but decided to look into the legality of the procedures under which the permits were granted.

The ASF found several reasons to consider the generation permits illegal, ranging from procedural to substantive issues, but most importantly the ASF relied on a study by the "Instituto de Investigaciones Jurídicas de la UNAM," a highly recognized academic legal research institution, which concluded that the legal framework under which private parties generate electricity is against the constitutional principle that reserves all electricity activities to the State.

The ASF recommended that the CRE take immediate action to correct the irregularities found in the review. The ASF also found that the public officials who participated in granting the generation permits had violated the law and were subject to sanctions and penalties.

The audit performed by the ASF to private power generation activities caused a great deal of turmoil among all participants in the sector. However, CRE officials and other private investors are certain that the ASF does not have legal authority to determine the legality of the generation permits granted to private parties. Last May President Fox, through the Energy Ministry and the CRE, filed a constitutional challenge before the Supreme Court against the ASF resolution.

Constitutional Challenge by the Energy Ministry Against the ASF

The constitutional challenge submitted by the Energy Ministry against the resolution by the ASF on the legality of the generation permits granted by CRE was admitted for review by the Supreme Court. The Energy Ministry is asking the Supreme Court to declare the ASF audit on the generation permits illegal. The Energy Ministry is alleging that:

- The ASF does not have authority to determine the legality of the generation permits granted to private parties by CRE;

- The ASF scope of authority is limited to review the adequate use of federal funds;
- Any resolution on the Constitutionality of the legal framework under which private parties may generate electricity is the exclusive authority of the judiciary power;
- The generation permits granted by CRE are in strict compliance with the laws and regulations that govern power generation activities by private parties.

The Supreme Court is in the process of reviewing the challenge and will take several months before it makes a final decision.

From a legal standpoint, the Constitution clearly establishes the division of powers and it is likely that the Supreme Court will rule in favor of the Federal Government. The Supreme Court will not let the authority of Congress take over matters which are strictly reserved to the Mexican Courts.

Conclusion

The need for investment in power generation activities in Mexico has raised political and legal debate on the legal framework. The Federal Government has tried to open the sector to private investment, but opposing political parties are against any type of privatization, not only by denying any type of reform, but also by accusing the Federal Government of violating the constitutional principles that reserve the electric sector to the State.

The issue of the constitutionality of the legal framework of the electric sector in Mexico has brought an unprecedented interaction among the Executive, Legislative and Judiciary Powers. Hopefully, the Supreme Court will issue a resolution free from political bias, which will bring legal certainty to the participants in this industry.

Author's Biography

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Recent Mexican Financial Reforms – Modernizing Mexico’s Financial Services Sector

By: Larry B. Pascal, Haynes and Boone, LLP (Dallas)¹

Introduction

It is difficult to exaggerate the importance of Mexico as a trade partner for Texas. Mexico shares a 1,254 mile border with Mexico and Texas’ exports to Mexico represent 43% of the Lone Star State’s total exports.² The effect of this significant level of trade with Mexico has not gone unnoticed by Texas lawyers who face increasing requests to assist clients with commercial opportunities in Mexico. Several Texas-based law firms have even responded by opening an office in Mexico or forming associations with Mexican lawyers.³

One historic obstacle to trade with Mexico has been Mexico’s lending rules. Mexico has not adopted the Uniform Commercial Code and its civil law lending rules are more reminiscent of the old chattel mortgage rules – technical and formalistic.

Despite this historic legacy, there is a growing awareness in Mexico that its lending rules are hurting the country and inhibiting badly-needed capital flows. Mexican government borrowing is already crowding out private sector needs⁴ and the government cannot borrow significantly more money without imperiling its hard-earned investment grade rating. In addition, Mexican banks are very conservative, lending only to their best customers and at much higher interest rates than in the US, ranging from 20% to 30%.⁵ In short, the high cost of capital is a serious obstacle that jeopardizes the overall competitive position of Mexico in the global economy.

Mexico’s Secured Lending Law Overview

Mexico’s secured lending laws have historically suffered from two flaws – (1) the high cost and expense in time and money of perfecting security interests in Mexico and (2) procedural and substantive rules that delayed foreclosure and enforcement of security interests in the event of default. For instance, perfecting a mortgage in Mexico City on a US\$1 million loan costs approximately \$6,300 in notary public and local property registry fees.⁶

Another historic challenge for creditors has been Mexico’s constitutional ban on self-help for seizure of collateral in the event of default.⁷ In practice, creditors have been forced to resort to judicial procedures to seize collateral and these procedures can be delayed by interlocutory appeals or constitutional challenges (“amparos”).

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² “Hot Stats-Texas Exports,” Dallas Federal Reserve Bank, August 14, 2003.

³ At this time, Haynes and Boone, Thompson Knight, Strasburger & Price, Winstead Sechrest & Minick, and Gardere Wynne Sewell have opened offices in Mexico or formed associations with Mexican law firms.

⁴ “Mexican Banks: An Endangered Species,” Fitch’s Rating Service, April 10, 2003.

⁵ “Won’t Lend,” The Economist, October 10, 2002.

⁶ Notary public fees are typically charged in Mexico per a published tariff for each state and vary based on the underlying value of the loan. Fees for a lien on personal property tend to be lower as a public broker (“*corredor publico*”) may be used instead.

⁷ Articles 14 and 16, Mexican Constitution.

June 2003 Reforms

In June 2003, the Mexican Congress adopted a series of reforms designed to increase lending, reduce transaction costs and interest rates, and improve juridical stability. These reforms amended several different laws, including but not limited to the Law of Negotiable Instruments, the Commerce Code, the Banking Law, and the Securities Law (collectively, the "2003 Reforms").⁸ In fact, the 2003 Reforms are the second round of important amendments to financial laws, with the first occurring in May 2000 (the "May 2000 Amendments"). A few highlights of the 2003 Reforms are discussed below.

Improvements in Foreclosure Procedure under Commercial Code – Faster Repossession of Collateral

The 2003 Reforms address changes to the Mexican Commerce Code designed to expedite commercial foreclosures and improve collection procedures by reducing the procedural opportunities of a debtor to delay foreclosure in court. The Reforms apply to both an ordinary collections action, as well as to the expedited commercial collection procedure ("Proceso Ejecutivo").⁹ The 2003 Reforms also provide that the Mexican Federal Civil Procedure Code applies in commercial collection actions, superceding state civil procedure rules in an effort to harmonize judicial proceedings throughout Mexico.

Conservation of Assets

For pledges of assets where possession remains with the debtor, the 2003 Reforms require debtors to use the assets in the ordinary course of business and conserve assets for the benefit of the creditor, imposing on the debtor a fiduciary duty.¹⁰ Violation of this high standard can result in criminal sanction.

Execution of Judgments Under Guaranty Trust and Non-Possessory Pledge – Elimination of Non-Recourse Restriction

One of the most important aspect of the Reforms addressed prior restrictions to two popular forms of collateral, the guaranty trust and the non-possessory pledge, the latter established under the May 2000 Amendments. With a guaranty trust (typically used in larger transactions), the debtor transfers title to the collateral to a trustee and retains a beneficial interest to use the property in the ordinary course of business. In the event of a default, the trustee is permitted to sell the trust assets for the benefit of the creditor. The guaranty trust was designed to avoid the Mexican constitutional restriction against self-help under the principle that legal title rests with a third party and not the debtor.

The non-possessory pledge has also been improved under the 2003 Reforms. Traditionally, under Mexican practice, the pledge of a good (i.e. granting a security interest) implied a transfer of possession to the creditor. Given that the debtor typically needed to continue to use the encumbered assets, a traditional pledge on important assets was not practical and effectively prevented capital formation. The May 2000 Amendments made this type of asset-based lending more viable.

⁸ Moreno, Luis, "Mexican Secured Lending Amendments," Texas Transnational Law Quarterly, November 2003.

⁹ Mexico's expedited commercial collections mechanism enables a creditor to quickly foreclose on collateral by requiring the court to seize sufficient assets to satisfy the judgment at the outset of the lawsuit. In general, in order to be eligible for this expedited procedure, the plaintiff must present a Mexican promissory note or other approved negotiable instrument evidencing the debt.

¹⁰ This concept was adopted under the May 2000 Amendments, but changes were adopted in the 2003 Reforms to improve the workings of the guaranty trust. For both types of security, it is possible to sell inventory in the ordinary course of business.

The acceptance of the guaranty trust and non-possessory pledge might seem like badly-needed and innocuous reforms to a Texas practitioner. However, the Mexican Congress was weary of the political response to these pro-creditor reforms and sought to reduce possible political opposition by making the use of either type of instrument non-recourse in nature. To this effect, creditors who used either a guaranty trust or a pledge without dispossession could not sue for any deficiency if the funds generated by the sale of the collateral were insufficient to cover the balance of the debt. Naturally, this important restriction limited the utility of the May 2000 Amendments and in practice forced lenders to seek excessive collateral in order to loan money under these instruments. The 2003 Reforms eliminated the non-recourse restriction, making both of these instruments more appealing to parties seeking to lend to Mexican companies.¹¹

Conclusion

The 2003 Reforms are the second phase of recent financial reforms, following the May 2000 reforms. They are a response to the domestic and international banking community's calls for improvements in these areas. While they are undeniably an improvement in some areas, some commentators are even expecting a third set of amendments before the completion of President Fox's six-year term in 2006, perhaps targeted to improvements in Mexican civil procedure practice.

¹¹ The non-recourse restriction was retained for certain home loans below a specified amount where at least 50% of the original loan had been paid at the time of default.