Structural Issues to Resolve in Mexico in Support of Electric Industry Reform

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Structural Reform: The Foundation

- Without a solid foundation, a building will likely fail to meet expectations.
- Building an electric market without the appropriate institutional foundation is no different.
- The foundation comes before the building.
Checklist for structural integrity

- Institutional challenges
- Competition
- Technological obstacles
- Reducing long-term barriers to competition
- Financial issues
- Social and environmental barriers
Mexico’s motives for electric reform

Lower Rates  ↔  Less Spending

Customers see:
- Lower tariffs
- Adequate investment in infrastructure
- Improved service quality

Government sees:
- Reduced subsidies
- Reduced infrastructure expenditures
- Eliminate need for backstop guarantees
Sensitive issues

- Electricity is heavily and unevenly subsidized
- “Privatization” in energy industry continues to be a political non-starter
- Labour unions are a large benefactor in current model; oppose meaningful reform
Structural change can be beneficial with or without electric market reform

- Institutional challenges
  - Mexican Constitutional conflict
  - Congressional accountability and maturity
  - Regulatory independence and transparency

- Competition
  - PEMEX: exercising market power in natural gas

- Technological obstacles

- Reducing long-term barriers to competition

- Financial issues
  - State utility accountability, solvency and budget uncertainty
    - Labour law, trade unions

- Social and environmental barriers
  - Subsidies
Constitutional Question

**Mexican Constitution**
“The nation will have exclusive responsibility to generate, deliver, transform, distribute and supply electric energy that has the objective of providing public service. . .”

**NAFTA**
An enterprise of another Party may acquire, establish, and/or operate [self generation], [co-generation] and [Independent Power that sells to the CFE].

**Mexican Electricity Law**
Self generation, co-generation, and Independent Power that is sold to the CFE … are not considered public service.
Congress

- Two houses: Deputies and Senators
  - Structural flaws and immaturity are showing up
  - Members accountable to their respective party, not to the people
- No attempt to clarify ongoing Constitutional conflict
- Rather, they are creating new conflicts
  - Challenge to the Supreme Auditor of the Federation
  - Regulation requiring PEMEX to construct and operate cogeneration at its refineries

- Resulting issues:
  - Current conflicts will likely not have a material impact on any specific foreign investment in electricity; but
  - Would one want to invest in Mexico? Is it worth the aggravation?
Regulatory capacity, independence and transparency

- Federal Energy Regulator (CRE); and Federal Competition Commission (CFC)
- Structures of CRE and CFC are generally favourable
  - are designed to allow for independence
  - some signs of immaturity
  - one limitation: their budgets are approved by Congress, subject to year to year funding restrictions
- Transparency
  - processes are very transparent
  - content of, and reasons for, decisions are not transparent
- Opportunity:
  - CRE could be given the responsibility to approve electricity tariffs
  - Content transparency would have to be improved
PEMEX: market power in natural gas

- Natural gas is the fuel source for over 30% of the electricity produced
- PEMEX has control over:
  - all natural gas production in Mexico;
  - most of the pipeline system;
  - most of the wholesale gas marketing; and
  - consumes nearly 50% of Mexico’s gas production
- It has demonstrated its willingness to exercise market power

Resulting issue:
- Would CFE operate any differently if it were placed in a similar position?
- CFE will not be able to get out of being IPP project counterparty and guarantor until a workable solution to market power is implemented
CFE and LyFC financial issues

- Operate under strict and uncertain budgets that are approved by Congress
  - CFE: gross revenue just covers operating costs
  - LyFC: gross revenue is 50% of operating costs
- CFE’s S&P BBB- foreign currency rating is driven by its relationship with the federal government
- Almost 90% of LyFC gross revenue is needed to cover its labour obligations
- Subsidies are funnelled through the utilities to customers
- Financial transparency is lacking

Opportunity:
- Make each company clearly and publicly accountable for costs and revenues
- Create Business Units within each company
- Move tariff setting process from the Congress to the CRE
Subsidy = Cost - Price

- Rarely do electric reforms work where the government hasn’t first dealt with excessive subsidies.
  - To the general public, reform success will be measured by “lower rates”
- Electric prices in Mexico are heavily subsidized
  - Average electricity subsidy in Mexico is 30%
  - Residential subsidies greater than 50%
- High energy prices are hurting the competitive position of Mexican industries

**Issue:**
- *Efficiency/productivity of the electric industry needs to improve; but*
- *Alone, productivity can’t overcome cost of the subsidies*
Potential Structural Reforms with or without electric market reform

- Modify the Constitution
  - Bring it in line with the Law and NAFTA
- Place CFE and LyFC under CRE regulation
  - De-politicize tariff-setting and regulatory processes
- Commercialize the CFE and LyFC
  - Government will have to be ready to forgive some of the debt it is owed by CFE and LyFC
- Strengthen CFC competence and reaction speed in energy market surveillance
- Limit subsidies, shift payment responsibility from utility to government
  - Subsidies should only go to the most needy
Structural Reform

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