

Analysis of Mexico's New Electric Industry Law

A new law (the “Electricity Law”) opening the electric industry to private sector participation in generation, transmission, distribution and power marketing activities became effective on August 12, 2014. The Electricity Law is part of a set of new laws to implement the constitutional energy reform that became effective on December 21, 2013.

This legal update addresses the main features of the new Electricity Law.

Background

The Mexican electric industry was governed by a restrictive legal framework that limited private sector participation and reserved most of the market to the state-owned Federal Electricity Commission (*Comisión Federal de Electricidad* or the CFE). Since 1992, private sector investment has been restricted to certain electric generation projects. Private companies could not take part in the transmission and distribution sectors, and there was no power trading market.

The CFE was vertically integrated—combining the operation of the national grid, its control of the wholesale generation market, a monopoly over transmission and distribution, and the supply to almost all Mexican customers. This structure caused inherent difficulties in adequately and efficiently supplying the electric energy demand in Mexico due, in part, to (i) CFE budgetary constraints, (ii) opaque rules for interconnection to the national grid and (iii) severe congestion, limiting transmission services. Because CFE's budget was in effect

controlled by the national treasury, the CFE long ago ceased to have the financial resources to properly maintain and expand the country's electric infrastructure.

Electric tariffs in Mexico were set by the Department of Finance (*Secretaría de Hacienda*) and not by the Energy Regulatory Commission (*Comisión Reguladora de Energía* or the CRE), the industry regulator, resulting in a tariff regime more responsive to political considerations than economic realities. While the industrial and commercial sectors generally do not receive government subsidies, agricultural and residential customers have received large subsidies. Despite these subsidies, residential consumers in Mexico pay, on average, higher tariffs than the same consumers in the United States.

The New Electricity Law

The Electricity Law provides separately for generation, transmission, distribution and power marketing activities.

From the regulatory side, three agencies will have primary responsibility for the sector. The Department of Energy (*Secretaría de Energía* or the SENER) will have the policy function; the CRE will have the regulatory function; and the CENACE, a new decentralized agency, will manage the power grid and the wholesale electric market.

The generation and wholesale of electricity will take place under a regime of free enterprise and

open competition. The CFE will be just one competitor in the new generation market.

While transmission and distribution facilities will remain under state ownership, the private sector will be able to participate in the construction, operation and maintenance of such facilities.

The operation of the National Electricity System, including the new wholesale electric market, will be run by the CENACE. This agency will also regulate open and non-discriminatory access to the transmission and distribution infrastructure.

The participants in the new wholesale electric market shall be the generators, power marketing companies and large end users (or “qualified customers”). The power marketing companies may sell power to end users (which may be qualified customers or regulated customers).

GENERATION SECTOR

- A permit from the CRE is required for the construction, ownership and operation by any qualified person of power plants with a generation capacity greater than or equal to 0.5 MW.
 - The permits shall also include the right to build, own and operate private interconnection lines to deliver power output to the grid.
 - Generation companies whose output cannot meet their contractual customers’ energy demand will have to purchase energy in order to meet such demand (i) in the wholesale electric market or (ii) through power purchase and sale agreements (PPAs) with other generators or with power marketing companies.
 - Generation companies can, in turn, sell their electricity (i) in the wholesale electric market or (ii) by entering into PPAs with a power marketing company, with qualified customers or with other generators.
 - Participation by generation companies in power marketing activities through affiliates is not prohibited.
- Generation companies that produce energy through renewable sources or clean technologies shall be eligible to receive tradable *clean energy certificates*.

POWER MARKETING (SUPPLIERS)

- To the extent a power marketing company sells power, it is called a *supplier*. Any qualified person may obtain a permit from the CRE to supply power to qualified or regulated customers.
- There are three different types of suppliers: (i) *basic service suppliers*, (ii) *qualified service suppliers* and (iii) *last resource suppliers*.
- The *basic supply* is the supply of electric power under a regulated tariff regime. Regulated customers are residential consumers and small businesses.
- The *qualified supply* is provided pursuant to freely negotiated PPAs with large end users.
- The *last resource supply* is provided to qualified customers in emergency cases under maximum rates.
- Power marketing companies may purchase electric energy (i) in the wholesale electric market or (ii) through PPAs with generators or other power marketing companies. Purchase of power by power marketing companies for resale to regulated customers must be carried out through competitive bidding processes.
- Suppliers (and qualified customers participating directly in the wholesale electric market) will be required to acquire clean energy certificates.

QUALIFIED CUSTOMERS

- The designation as a *qualified customer* is attached by registration with the CRE. The applicant shall demonstrate that its existing demand exceeds certain thresholds (initially 3MW, with such threshold being reduced to 1MW by the third anniversary of the effective date of the Electricity Law).

- A qualified customer may purchase energy (i) in the wholesale electric market or (ii) under a PPA with a generation company or a power marketing company.
- There will be obligatory requirements for the acquisition of *clean energy certificates* by qualified customers that purchase energy directly in the wholesale electricity market.

WHOLESALE ELECTRIC MARKET

- It is a spot market operated by the CENACE where generators, suppliers and qualified customers (acting directly and not through a power marketing company) are gathered for selling and buying electricity at real-time system marginal costs.
- Generation companies must operate their units in accordance with the dispatch orders of the CENACE and coordinate their maintenance operations with the CENACE.
- The CENACE will dispatch the system's power plants based on a merit order of ascending operating costs (regardless of their contracted capacity under PPAs), under which the lowest operating cost power plant satisfies system energy demand before the next lowest operating cost plant is dispatched.
- The CENACE can form partnerships with private parties in order to provide auxiliary services for spot market operations.

TRANSMISSION AND DISTRIBUTION

- The CFE through its affiliates (or other state-owned companies) will own the transmission and distribution lines and will provide the service of transmission and distribution of electricity. However, such entities will not directly buy or sell the electricity that flows through their lines.
- Tariffs for transmission and distribution services will be regulated by the CRE.
- The SENER or the CFE's affiliates may form partnerships or reach agreements (through public bidding processes) with private entities in order to carry out the financing,

installation, maintenance, management, operation and expansion of transmission and distribution infrastructure.

- Transmission and distribution grids will be under a “not unduly discriminatory open access” regime managed by the CENACE.

CFE

- The new CFE will operate through separate affiliated companies to take part in every sector of the electricity industry.
- The new CFE will have to compete on an equal footing with private parties in the generation and marketing of electricity, but will remain the exclusive provider of transmission and distribution services.

CLEAN ENERGY CERTIFICATES

- The SENER will establish the criteria for issuing clean energy certificates to generators, which will relate to energy generated by clean technologies (as defined in the Electricity Law).
- The SENER will also regulate the obligation of the suppliers and qualified consumers that participate in the spot market to acquire clean energy certificates, in proportion to energy purchased or consumed.
- The clean energy certificates shall be negotiable.

USE OF LAND

- The transmission and distribution of electricity have a special priority over any other activities that involve the use of the surface and subsurface of lands lying within the limits of the respective projects, including hydrocarbon-related activities. The affected lands are subject to legal easements for the installation of transmission and distribution networks.
- The Electricity Law contemplates the right of occupation and use of land owned by third parties for the location, construction and operation of site-specific generation projects (ie., hydroelectric plants) and transmission and distribution facilities. The consideration

for the purchase, use or occupation of land, goods or rights that are necessary for conducting these activities shall initially be negotiated directly between the interested parties. If they do not reach agreement, the industry participant may request that (i) a district judge grant a legal easement or (ii) the Ministry of Agricultural, Territorial and Urban Development conduct a mediation. Lack of agreement after the mediation may also result in the imposition of a legal easement.

NATIONAL CONTENT

The SENER will establish a minimum national content in the new projects related to the financing, construction, maintenance and operation of transmission and distribution facilities. This requirement will be subject to availability in terms of comparable quality, cost and time or performance.

Conclusion

The new Electricity Law establishes a legal framework for electricity-related activities in Mexico, and has structurally changed the national electric industry.

Its fundamental principles are:

- The generation and wholesale of electricity will take place under a regime of free enterprise and open competition.
- The CFE will no longer have a regulatory function and will not manage the electric power system.
- Transmission and distribution networks will be managed by an independent agency under an open access regime and regulated transmission and distribution tariffs.
- Large end users of power will be free to choose their suppliers and the terms and conditions of power supply.
- The new law provides for mechanisms to encourage the use of clean energy sources.

- The new law also provides for a mechanism to solve disputes concerning the required use of lands owned by third parties.

Much remains to be determined by regulations to be proposed and implemented in regard to this new law, but today there is a detailed picture of Mexico's future electric power sector.

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