

ClientAlert

Energy, Infrastructure and Project Finance

August 2014

Energy Reform With Regards to Electricity

On August 11 2014, a package of reforms to Mexico's secondary energy laws (the "Energy Reform") was published. This Energy Reform is based on the amendment of Articles 25, 27, and 28 of the Constitution and the corresponding inclusion of 21 temporary articles regarding energy issues in the Constitution, which changes went into effect on December 21, 2013 (the "Constitutional Reform"). The aforementioned legal changes were enacted pursuant to the objectives established by the 2013-2018 National Development Plan.

In addition to the modification of various existing laws, the Energy Reform contemplates the issuance and publication of the following nine new laws:

- (i) Hydrocarbons Act;
- (ii) Hydrocarbon Revenues Act;
- (iii) Petróleos Mexicanos Act;
- (iv) Mexican Oil Fund for Stabilization and Development Act;
- (v) Creation of the National Agency for Industrial Security and Environmental Protection of the Hydrocarbon Sector Act;
- (vi) Electric Industry Act;
- (vii) Geothermal Energy Act;
- (viii) Federal Electricity Commission Act; and
- (ix) Coordinated Regulating Energy Sector Agencies Act.

This Client Alert is being issued to clients for the purpose of explaining the contents of the Energy Reform as specifically regards the electricity industry and, in particular, the most important aspects of the Electric Industry Act (the "Act").

A. Scope of the Reform as Regards Electricity

The Constitutional Reform substantially modified the pillars of the electrical industry in Mexico. Prior to the Constitutional Reform, the generation, transmission, distribution, and marketing of electricity, to the extent that it was deemed a public service, was an exclusive activity of the State, and was carried out by a state-run entity known as the Federal Electricity Commission (*Comisión Federal de Electricidad*, typically referred to by its Spanish initials, "CFE").



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Following the Constitutional Reform, the state has maintained its strategic functions with regards to the planning and control of the National Electric System (*Sistema Eléctrico Nacional*, typically referred to by its Spanish initials, "SEN"), as well as responsibility for the transmission and distribution of electricity, which continue to be regarded a public services and, consequently, strategic activities reserved for the State; however, private enterprises may now participate in the generation and marketing of electricity, and may also participate in transmission and distribution activities to a limited extent, through contractual arrangements.

As a part of the Energy Reform, CFE will cease to be a public instrumentality, and will instead become a "state productive company". Through various affiliate entities, including both "state productive" subsidiaries and other affiliates (i.e., companies of a "private" nature), CFE will be able to compete with private enterprises in the electricity generation and marketing industry. At the same time, CFE will continue to manage transmission and distribution of electricity as a public service. In its capacity as a state production company, CFE will enjoy a special legal regime with regards the following: i) procurement, leases, services, and construction work; ii) assets; iii) budget and public debt; iv) administrative responsibilities; and v) remunerations, as well as with regards to other matters pertinent to the effective realization of its goals.

The Act abrogates the Public Service for Electrical Energy Act¹ and aims to regulate the planning and control of SEN, the transmission and distribution of electricity as a public service, and the electricity industry activities identified above. Below is a brief description of the most important aspects of the Act.

B. Regulated Activities of the Electrical Industry in Mexico

I. Generation

The Act distinguishes between "Generators" and "Exempt Generators". This distinction depends on whether a generation permit is required for a given generator. The Energy Regulatory Commission (*Comisión Reguladora de Energía*, typically referred

to by its Spanish initials, "CRE") is empowered to grant generation permits.

Electric generation plants with a capacity equal to or greater than 0.5 MW, as well as plants of any size that are represented by a generator in the Wholesale Electricity Market², are required to obtain a generation permit in order to generate electricity. The holder of such a permit is defined in the Law as a "Generator"; as opposed to an "Exempt Generator"; which refers to an owner or holder of one or more electric plants that neither require nor hold a permit to generate electricity.

i. Generators

Generators may conduct marketing activities related to electricity produced by their plants, with a few exceptions: They may not provide direct electrical supply (i.e., the sale of energy to "Final Users"³) nor may they represent Exempt Generators on the Wholesale Electricity Market. Generators are entitled to sell their electricity either a) on the Wholesale Electricity Market or b) through Electricity Hedge Contracts⁴ with marketers, Suppliers and/or Qualified Users⁵. Electricity marketing is discussed in greater detail in Section iii below.

A Supplier is an entity conducting marketing activities which holds a permit to provide direct electrical supply to final users and to represent Exempt Generators on the Wholesale Electricity Market (a "Supplier").

The activities discussed in this Section are to be regulated in accordance with Market Rules⁶, which will subsequently be issued by the National Energy Control Center ("CENACE") and the CRE. As a result, the detailed regulations governing the general procedures discussed above will be more precisely defined once such market rules are issued.

ii. Exempt Generators

Exempt Generators cannot conduct marketing activities (i.e., they cannot participate in the Wholesale Electricity Market on their own behalf). They can sell electricity that they generate only to a Supplier, which will in turn represent the Exempt Generator on the Wholesale Electricity Market.

¹ Except for the provisions of the organic structure of the Federal Commission of Electricity, which will continue to be applicable until the Federal Electricity Commission Law becomes effective.

² The spot market operated by CENACE in which market participants conduct transactions involving the purchase and sale of electric energy and other identified products.

³ Final Users are defined as individuals or corporate entities that acquire electrical supply at their load centers for their own consumption, or for consumption within their facilities.

⁴ Electricity Hedge Contracts refer to an agreement between market participants by means of which there is an obligation to sell and purchase electric energy or Associated Products at a particular future time or date, or for making payments based on the prices of said products.

⁵ Qualified Users are those users whose electricity consumption surpasses a threshold established by the CRE, as well as those users who currently hold permits for electricity self-supply, co-generation, or importation. See Section III(ii).

⁶ Administrative provisions that will govern the Wholesale Electricity Market, and which will be issued by the CRE and CENACE.

An Exempt Generator may also dedicate a portion of its electricity production for its own electrical needs, which falls under the category of “isolated supply.”

iii. Isolated supply or self-consumption.

The Act recognizes the category of “isolated supply,” by which it designates the generation or importation of electricity for the satisfaction of an entity’s own internal electricity requirements or for export, without the utilization of the SEN.

Power plants may designate all or part of their production for purposes of isolated supply, and load centers may satisfy all or part of their electricity needs by means of isolated supply. In the event that an electric plant designates only part of its generated power for isolated supply, such plant can be connected to the SEN in order to allow for the sale of surplus electricity. This sale of surplus electricity can be utilized by either a Generator or Exempt Generator in accordance with the applicable procedures noted above, as long as the relevant entities have entered into an appropriate interconnection contract.

iv. Distributed Generation

The Law recognizes “Distributed Generation” as a method of generation defined by meeting the following criteria: a) it is generated by an Exempt Generator; and b) it is generated in an electric plant that is interconnected to a distribution circuit that contains a high concentration of load centers (“Distributed Generation”).

In simple terms, Distributed Generation consists of the generation of electricity on a small scale and with a direct connection to a distribution network, and is characterized by being installed at locations close to the site of consumption (i.e., it does not need to be dispatched through transmission networks).

It is expected that, by means of Distributed Generation, microgenerators of renewable energy will be able to sell the electricity they produce in a simpler and more efficient manner than larger-capacity sources. General regulations to be issued by CENACE, the CRE, or the Ministry of Energy (the “Ministry”) will endeavor to govern the sale of electricity produced via Distributed Generation by Exempt Generators.

II. Transmission and Distribution

In accordance with the Constitutional Reform, the state retains responsibility for the transmission and distribution of electricity for public service purposes, which service is to be provided through

the CFE and/or its subsidiary productive companies. The owners of the transmission and distribution networks (CFE or another state-productive company) are responsible for the operation of such networks, in accordance with CENACE regulations.

CFE shall provide transmission and distribution services, as well as certain other ancillary activities, through a subsidiary productive company, which shall be legally independent from other subsidiaries of the CFE.

In addition to the instructions of CENACE, CFE must operate the national transmission network and the general distribution networks (i.e., the SEN) in compliance with certain general service conditions, to be issued by the CRE, governing the transmission and distribution of electricity as a public service (the “General Conditions”).

Tariffs for transmission and distribution services provided by CFE will be regulated by the CRE. The CFE, in its capacity as a Generator, must pay the same carrier fee (as established by the CRE) as a private Generator would pay for the same services.

i. Interconnection to the SEN

CFE will be required to interconnect its networks with all electric plants and load centers whose representatives request such an interconnection, under conditions that are not unduly discriminatory, so long as the facilities requesting such interconnection have complied with the technical requirements established by CENACE.

For the purpose of complying with this open-access principle, the Market Rules will define the criteria to be utilized by CENACE in order to establish an order of priority for interconnection requests. In no case shall a generation permit be used as a criterion for such prioritization.

Once CENACE has requested the specifications required for the interconnection, the interested party may request that CENACE incorporate the relevant project into the expansion and modernization plans to be developed for the SEN. In the event that the project in question is not included in such plans, the Generator, Exempt Generator, or Final User (as applicable) may choose to construct the relevant infrastructure at their own expense, or to make contributions to the Transporter or Distributor in order to enable such projects to be completed. The interested party will also have the option of acquiring the corresponding Transmission Financial Rights⁷ or, alternatively, receiving any revenues resulting from the sale of such rights, pursuant to the terms of the Market Rules.

⁷ The right and corresponding obligation to receive and pay the difference resulting from Marginal Prices between the source and the load. The Marginal Price is the Price of electric energy in a given node of the SEN, calculated in accordance with Market Rules. Generators will be paid a price in accordance with the node that delivers their energy, and users will pay this price according to the node from which they receive the energy.

ii. Expansion of the SEN

The CFE will carry out expansion and improvement projects for the SEN to be developed in accordance with relevant modernization and expansion plans, with the understanding that CENACE may propose such projects to the Ministry.

In addition to the foregoing, the State may, through the Ministry, enter into contracts and form associations with private parties so that the latter can conduct, on behalf of the State, such financing, installation, maintenance, management, operation, and expansion of infrastructure as may be necessary to improve the transmission and distribution of electricity for public use. These contracts shall be subject to tariff regulations, as well as to conditions for the provision of services to be issued by the CRE, among other requirements.

III. Marketing and Supply

Marketing includes, but is not limited to, the following activities: i) providing electric supply to Final Users; ii) representing Exempt Generators in the Wholesale Electricity Market; iii) conducting Purchase and Sale Transactions⁸; iv) entering into Electricity Hedge Contracts in the Wholesale Electricity Market; and v) acquiring transmission and distribution services on the basis of regulated tariffs.

Conducting marketing activities requires entering into a Market Participant Contract⁹ with CENACE. Additionally, for the activities numbered i) and ii) above, the relevant entity carrying out such activity must also be a Supplier possessing the relevant permit issued by the CRE.

The Act distinguishes among different kinds of Suppliers on the basis of the kind of users to whom they provide supply. In this regard, a division of Final Users into Basic Supply Users and Qualified Users has been provided, as follows:

i. Basic Supply Users

Basic Supply Users are residential users and small- to medium-scale commercial users. "Basic Supply" is classified as a high-priority activity and will initially continue to be provided only by the CFE, through a subsidiary. Tariffs for Basic Supply will remain regulated by the Federal Government through the Ministry of Finance and Public Credit.

Basic Services Suppliers must enter into contracts for electricity and Associated Products which allow them to supply Basic Supply Users, including Electricity Hedge

Contracts. Such contracts will be available exclusively through auctions to be conducted by CENACE.

ii. Qualified Users

Qualified Users consist of those users whose electricity consumption surpasses a threshold to be established by the CRE, as well as those users who currently hold self-supply, co-generation, or importation permits.

Qualified Users may acquire electricity: i) from Generators, by means of entering into hedging contracts; ii) independently, through the Wholesale Electricity Market (in which case they will be called "Market Participant Qualified Users"; or iii) through a Qualified Services Supplier, the latter option having the advantage of providing comprehensive service without the need for the end user to actively administer its electricity consumption.

Any Qualified Services Supplier can offer electricity supply to Qualified Users, on an open competition basis. Both the CFE and Qualified Services Suppliers must purchase the energy that their clients require, either by entering into contracts with Generators or in the Wholesale Electricity Market.

The Act also provides for "Last-Resort Supply," i.e., supply that is provided at maximum prices to Qualified Users for a limited time for the purpose of maintaining continuity of service when the power supply of a Qualified Services Supplier stops providing electricity. The "Last-Resort Supplier" will offer to supply Qualified Users that require such stopgap electricity, so long as such users' load centers are located in zones where such suppliers operate, and provided that supplying the necessary electricity is technically feasible.

C. Wholesale Electricity Market

Through the Wholesale Electricity Market, which will be operated by CENACE, the Suppliers, Generators, Marketers, and Qualified Users who participate in the market may purchase and sell the following: i) electricity; ii) Related Services¹⁰ included in the Wholesale Electricity Market; iii) Power; iv) Transmission Financial Rights; v) Clean Energy Certificates; and vi) other products, collection rights, and the right to impose penalties required for the efficient functioning of the SEN (collectively, "Purchase and Sale Transactions"). All Purchase and Sale Transactions on the Wholesale Electricity Market shall be regulated by the Market Rules.

CENACE will determine the assignment of electric plants on the basis of safety criteria and economic efficiency.

⁸ As defined by Section C of the present document.

⁹ A contract that the participants enter into with CENACE in order to conduct legally permitted transactions in the Wholesale Electricity Market.

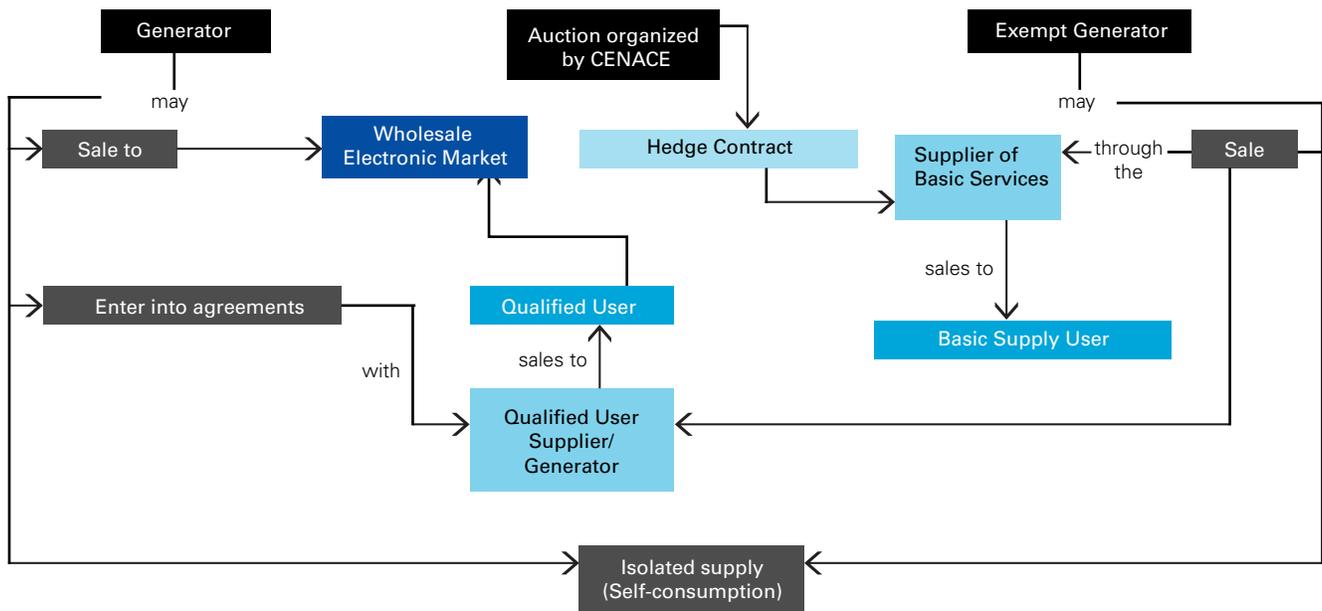
¹⁰ Services tied to the operation of the National Electric System, which include, but are not limited to, the following, as defined in the Market Rules: operational reserves; rolling reserves; regulation of frequency; regulation of voltage; and launching emergency operations.

Representatives of power plants, and those offering reductions in electricity consumption by Final Users in accordance with Market Rules (hereinafter, “Controllable Demand”), will, at times of maximum demand, offer to the Wholesale Electricity Market all available capacity in such electric plants and all Controllable Demand, respectively, provided that they remain in compliance with their operational parameters and requirements. Prices in connection with transactions conducted on the Wholesale Electricity Market will be calculated by CENACE on the basis of offers received from the Generators, with the understanding that the offers made by Generators must be based on their operational expenses, in accordance with the terms of the Market Rules.

In the event that any action or transaction has the effect of manipulating market prices, the CRE will instruct CENACE to rectify the relevant invoicing, and will issue the necessary account statements in order to reverse the monetary damages caused by such manipulative actions or transactions.

The Act provides that any agreement, arrangement, or coordination among market participants that has the intent or effect of restricting the efficient functioning of the Wholesale Electricity Market will be considered a collusive monopolistic conduct.

For greater detail on the structure of the Wholesale Electricity Market, please consult the following chart:



D. Clean or Renewable Energy

As a general matter, the Act does not regulate the clean or renewable energy sources used for the generation of electricity, with two exceptions: the implementation of clean energy requirements and certain provisions regarding Distributed Generation.

Clean energy is defined in the Act as energy produced by sources and processes whose emissions and waste products (if any) do not surpass certain regulatory thresholds (“Clean Energy”). It is noteworthy that the Act includes thermonuclear energy in its non-exclusive listing of Clean Energy sources, based on the above criteria.

Certain types of parties are subject to specific clean energy requirements, including: i) Suppliers; ii) Qualified Users who participate in the Market; and iii) Final Users who supply themselves via isolated supply. In order to satisfy their clean energy requirements, these types of entities will need to acquire Clean Energy Certificates demonstrating that Clean Energy accounts for a certain percentage of the total electrical energy consumed in their load centers.

Clean Energy Certificates are negotiable instruments that may be bought and sold through the Wholesale Electricity Market, and are issued by the CRE. These Certificates establish the production of a specific quantity of electrical energy by means of Clean Energy sources, and are used to demonstrate compliance with the consumption requirements described above.

E. Temporary Regime and Issues Pending Definition

The Act provides for a temporary regime in order to facilitate the gradual implementation of the Act, and in order to ensure that the objectives set forth in the Act are achieved. During this transitional period, the CFE will continue to provide generation, transmission, distribution, and marketing services as it has previously done. Likewise, CENACE will continue to exercise operational control of the SEN.

Within six months of the Act's entry into effect, the Federal Executive will issue a decree that establishes CENACE as a decentralized public instrumentality (*organismo público descentralizado*), setting forth its organizational structure, responsibilities and authority.

The CFE will be required to segregate its various activities, namely generation, transmission, distribution, and marketing, providing each functionality with separate accounting, operational and legal capacities. However, the Act does not provide any deadline for CFE to enact this separation. Contracts entered into by and between CFE and third parties that are currently effective, or that have contingent liabilities on the date of such separation, will be transferred to productive state companies, productive state subsidiaries, affiliates, or to CENACE, as applicable, under terms defined by the Ministry. This transfer will under no circumstances result in the termination of such contracts.

The CRE must issue the model contracts required by Act within nine months of the Act becoming effective.

Self-supply permits and contracts, small-production cogeneration, independent production, importation, exportation, and other particular uses authorized in accordance with the Public Service for Electric Energy Act will continue to be governed by that Act, insofar as it does not conflict with the present Act. Permit-holders may request that their permits be changed to generation-only permits for the purpose of engaging in activities permitted under the Act. Any such conversion of a permit can be rescinded one time within five years of the initial conversion, at which time the conditions of the original permit and of any corresponding interconnection contracts shall be reinstated.

The terms of existing interconnection contracts entered into under the Public Service for Electric Energy Act ("Inherited Interconnection Contracts") will remain effective, but will not be extended once they expire. The benefits granted under those contracts (e.g., recognition of self-supplied power, postage stamp scheme transmission tariffs, the energy bank, and other benefits granted to renewable projects) will remain effective under their stated terms until the expiration of the relevant interconnection contract.

An Inherited Interconnection Contract can be entered for a period up to 20 years under either of the following circumstances:

- (i) The interested party has requested a generation permit and paid the corresponding fees prior to the entry into force of the Act, and has complied with both of the following requirements: a) it has shown its interest in continuing with the project within 60 days following the entry into force of the Act; and b) it provides evidence to the CRE, no later than December 31, 2016, that it has agreed on the financing arrangements for the complete project and to acquire the main items of required equipment, and has disbursed at least 30 percent of the total investment required for the acquisition of fixed assets in connection with the project; or
- (ii) When capacity transmission has been assigned by means of an "open season" procedure organized by the CRE prior to the entry into force of the Act, and the interested party has complied with all required contributions and guarantees.

As noted in Section B III(ii), users who hold permits for self-supply, cogeneration, or importation at the time that the Act becomes effective will acquire the status of Qualified Users. During the first full year of the Act's effectiveness, load centers reporting a demand equal to or greater than 3 MWs may be included in the registry of Qualified Users. After the Act has been in effect for one full year, the threshold level for a load center to be considered a Qualified User will be reduced to no greater than 2 MWs, and by the end of the second year, this threshold will be reduced to no greater than 1 MW.

Certain issues remain pending further clarification. Specific secondary legislation is likely to be enacted in the near term for the regulation of clean and renewable energy sources, which will replace the existing regime.

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