Mexico looks forward to era of public-private deals

By Francisco Forastieri Muñoz, Cecilia Quintanilla and John E Rogers of Strasburger & Forastieri SC

In the past few years growing attention has been given to ways to structure the relationship between the public and private sectors in connection with infrastructure and other projects in many countries, in both the developed world and in emerging markets. After some controversial experiences with privatization of activities previously managed by the public sector, such as the political upheaval surrounding the privatization of the water systems in Bolivia, policy-makers have given increasing attention to alternatives to the full privatization of such activities. The goal is to take advantage of private sector skills and reducing public budgetary burdens without fully giving up control of the asset or service in question.

The largely successful experience of the UK with public-private partnerships (PPPs) has led many countries to explore the possibility of developing similar structures. A couple of years ago Mexico joined the list of those countries, with the goal of developing a structure that would ease the budgetary burden on the Mexican government but at the same time ensure that specific criteria would be established to: (i) determine where such a structure would be financially advantageous to the government and (ii) measure the performance of the private sector participant. Recent developments have served to strengthen the trend towards these new structures.

Mexican predecessors of PPPs

Mexico has already had substantial experience with structures in which the public and private sectors have worked together on projects. In part this has been because there are some areas of activity in which legal and/or constitutional constraints have prevented full privatization, such as toll highways and energy projects. In these areas, the government has granted concessions to private companies to build and operate (but not to own) toll highways, and to enter into contracts (comparable to concessions) with private companies to provide services to the government-owned energy companies *Petróleos Mexicanos*, *Comisión Federal de Electricidad* and *Luz y Fuerza del Centro*. In some of these cases, to obtain project financing for the transaction, the governmental entity has been required to incur long-term take-or-pay obligations to the private investor in the project or (in the case of toll highways) to agree to extend the term of the concession if traffic estimates are not borne out in practice.

In the past 10 years the Mexican government has placed increasing reliance on devices for deferring the budgetary impact of its obligations related to large infrastructure projects. The most frequently used device in the energy field has been the so-called Pidiregas (*Proyectos de Infraestructura Financiada con Impacto Diferido en el Gasto* or Infrastructure Projects Financed with Deferred Expense Impact). Pidiregas projects have involved private sector investment and project financing with various types of government support, such as CFE agreements to purchase electricity under power supply contracts, Pemex agreements to purchase natural gas produced under gas compression contracts, build-operate-transfer arrangements for power plants and the like. In many cases the projects can be characterized as based on service contracts with government agencies, in which separate risks have been allocated to the public and private sectors. However, there has been a perception on the part of the government that in some cases they have assumed an undue portion of the risks. Also, questions have been raised in recent years as to whether the contingent liabilities incurred under Pidiregas arrangements have created excessive financial exposure for the government.

The largely successful experience of the UK with public-private partnerships has led many countries to explore the possibility of developing similar structures

From the government's perspective, another disadvantage of many of these projects is that no precise cost-benefit analysis was done at the outset to determine whether the private sector could in fact provide a better service than the public sector. At the same time, there were often no detailed performance criteria established to ensure that a high quality of service would be provided throughout the life of the concession or contract, and that the allocation of risks between the public and private sectors was carefully evaluated and structured for both the construction and operation phases of long-term projects.

The PPS rules

Since 2002, the Mexican government has undertaken efforts to implement a PPP scheme through what have been called Projects for the Provision of Services (*Proyectos para Prestación de Servicios* or PPSs), and which initially have been focused on the furnishing of services related to what has been termed social infrastructure. In March 2003 the Mexican Ministry of Finance and Public Credit (the *Secretaría de Hacienda y Crédito Público* or Hacienda) and the Ministry of Public Functions (the *Secretaría de Función Pública* or SFP) formed a task force to establish the guidelines for such PPS projects. The rules promulgated by Hacienda and the SFP were amended in April 2004 and are called the Rules for Carrying Out Projects for the Furnishing of Services. These rules serve, among other things, as the basis for determining whether a particular project can qualify to be treated as a PPS in Mexico. The PPS appears to be the closest

Francisco Forastieri Muñoz

Forastieri Abogados, SC

Francisco Forastieri is the founder of Forastieri Abogados, SC. He is a graduate of the Escuela Libre de Derecho in Mexico City and was admitted to practice in 1985. Since 1995, he has been a lecturer at the Law School of the Universidad Iberoamericana in Mexico City. He is a member of the Mexican Bar Association and has also served as member of the board of directors of several Mexican companies.

Mr Forastieri focuses his practice on corporate and business law. He has extensive experience in mergers and acquisitions, private equity and venture capital, finance and securitization transactions, and related issues. He also provides advice in the areas of foreign investment, telecommunications and entertainment law. Francisco Forastieri is fluent in English.

Cecilia Quintanilla

Forastieri Abogados, SC

Cecilia Quintanilla Madero has been counsel of Forastieri Abogados, SC since 2004. Her practice focuses on public bids and contracts, project finance, intellectual property and arbitration. She graduated from Mexico City's Escuela Libre de Derecho, and was admitted to practice in 1990. Since then, she has obtained several graduate diplomas from institutions in Mexico and abroad, involving notarial law, small and medium-sized enterprises, alternative dispute resolution, and international financial law. Before joining the firm, Ms Quintanilla worked as a legal practitioner for several law firms and companies in Mexico City, and between 1998 and 2004 she headed her own law firm, Quintanilla Madero y Asociados, SC. Ms Quintanilla is a member of the Mexican Bar Association and a member and licensed arbitrator of the International Chamber of Commerce.

John E Rogers

Strasburger & Price, SC

John Rogers is resident partner in Mexico City of Strasburger & Price, SC, a subsidiary of Strasburger & Price LLP, an international law firm with offices in Austin, Dallas, Houston, San Antonio, Collin County (Texas), Washington DC and Mexico City. He has been a member of the New York bar since 1971 and practises as a foreign legal consultant in Mexico, where he has resided for 18 years. He is a graduate of Harvard College and Columbia Law School.

Rogers speaks English and Spanish. His practice focuses on international banking, financial and corporate transactions. He has experience in the areas of toll road financings and restructurings, natural gas concessions and transportation contracts and a variety of bank lending transactions including project finance deals. He also has expertise in foreign investments and joint ventures.

thing in Mexico to a public-private partnership as experienced in the UK and other countries.

The PPS rules contemplate that a PPS can include any long-term services contract (a Services Contract) between a governmental entity (the Entity) and a private company or individual (the Investor), whereby the Investor provides services, either through assets it owns or develops or assets owned by a third party (including the Entity), and for which the Entity pays a specified compensation. The PPS must provide a better performance of the Entity's assigned functions (as specified under applicable law or in the National Development Plan) than the Entity could provide on its own. The Entity must determine which functions could be better served by the Investor through a PPS, but cannot include in PPS functions those that under applicable law are required to be furnished directly by the Entity. This would appear to exclude from PPS functions the public service of electricity, which under current law and constitutional provisions is reserved to the CFE and Luz y Fuerza del Centro. However, the rules may permit the Investor to provide services to an Entity that, in reliance on those services, would furnish related services to the public. For example, it would appear that a PPS could involve an Investor building and operating a power plant to provide electricity to the CFE, thereby enabling the CFE to provide electric power to the public.

Hacienda plays a key role in the PPS process. Under the PPS rules, before the initiation of any PPS procedure, an authorization must be obtained from Hacienda under Title VI of the PPS rules; and once that authorization is granted, a separate and additional authorization must be obtained from Hacienda under Title VII before entering into a PPS Services Contract. In granting such authorizations Hacienda must determine that a cost-benefit analysis and budgetary impact analysis, prepared in accordance with general guidelines issued by Hacienda for this purpose, have been performed that show that the project is a desirable method for providing the relevant services to the public in comparison with a hypothetical case in which the services are provided without a PPS. An Entity is required to confirm that the contracted service is received before making any payment to an Investor, and any such payment is required to be treated as a current expense, funded through a previously authorized yearly federal budget allocation, despite the fact that it is made under a long-term contract (to avoid the Services Contract being considered long-term public debt of the Entity). The Entity is required to give high priority to using the amounts authorized pursuant to the budgetary allocation, to pay the designated project costs.

The contracting procedure must satisfy the public procurement requirements in the Law of Public Sector Acquisitions, Rentals and Services, which regulates all federal entities and projects funded either in whole or in part with federal funds. The Acquisitions Law requires, among other things, that PPS contracts must be awarded to the bidder that: (i) demonstrates that it has the experience and ability, both technical and financial, to provide the required services and (ii) submits the lowest economic bid as the amount to be paid by the Entity for the designated services.

The rules further provide that the contracting Entity must appoint a project manager for each PPS, who will be responsible for coordinating the PPS activities, including obtaining the cost-benefit analysis, requesting the necessary Hacienda approvals, ensuring that the PPS rules are complied with and reporting periodically to Hacienda and the SFP. The project manager may, if they deem it appropriate, create a consultative com-

mittee to oversee the project, and if so the committee must include representatives of Hacienda and the SFP. The PPS contract may permit the Entity to acquire project assets owned by the Investor, subject to the Entity having enough funds in its budget at the time of acquisition. The Federal Budget should expressly cover contingent circumstances such as the dissolution or bankruptcy of the Investor and other defaults under the PPS contract, which may lead to the Entity acquiring project assets. The PPS contract must in any event contain a *specific methodology* for evaluating the performance of the Investor, and provide that if the Investor does not comply with the applicable criteria the Entity may deduct from the service fee payments amounts (determined in accordance with a specified formula) designed to penalize the Investor for any deficiency in the service provided.

PPS contracts must also set timeframes for the delivery of services, bonds, late service delivery issues, events of *force majeure*, insurance provisions, choice of law, change of control of the Investor, early termination issues and conflict resolution mechanisms, among others.

First PPS deals

The Mexican government has been proceeding under the PPS rules to engage in transactions with the goal of taking advantage of the private sector's skills and financing ability, and reducing the government's budgetary exposure. The three project areas in which the government has chosen to focus initially are highways, health and education. Four pilot PPS projects are formalizing their tendering processes during 2005, and there is a pipeline of 16 other potential projects that are still being defined. The first projects to be considered were: (i) the widening and refurbishment of the Querétaro-Irapuato and Irapuato-La Piedad highways, (ii) the construction and operation of a public hospital in the Bajio region and (iii) the development of a public polytechnical university in San Luis Potosí. These Mexican government initiatives open a window of opportunity to private companies interested in participating as private contractors under PPS schemes. Because a core principle of any PPS is the allocation of risk to the party that is best suited to manage risk at the least cost, this should result in better control of the complete range of project risks throughout the life of the project, making better use of public money while retaining control of core areas of responsibility by the public sector.

The proposed PPS project for a public hospital in the Bajío region provides an example of how such projects have been structured so far. The project is expected to be awarded in 2005 pursuant to an international public bid. A form of Services Contract has been developed and distributed to bidders. The Services Contract would be between the Investor and the Ministry of Health and would require, among other things, that the Investor: (i) be a Mexican person with a taxpayer registration although, in the case of a Mexican company, it can be owned by foreign shareholders; (ii) have obtained the concession for the project by having won the bid process; (iii) commit to provide services over a 25-year period, including the construction and operation of the hospital, but excluding

F O R A S T I E R I | *abogados*

A firm of Mexican lawyers with offices in Mexico City and extensive experience in various business law areas

STRASBURGER & PRICE

A firm of U.S. lawyers with offices in Austin, Dallas, Houston, San Antonio, Collin County (Texas), Washington, D.C. and Mexico City

are partners in

STRASBURGER & FORASTIERI

A joint venture firm formed to assist clients in cross-border matters involving Mexico

Main departments / practices

Corporate Law
Loan Transactions and Restructurings
Energy
Public Works Projects, Procurement Issues
Telecommunications
Real Property, Leases
Franchise and Distribution Law

Mergers & Acquisitions
Banking and Securities Law
Antitrust
Foreign Investments
International Trade
Intellectual Property
Tourism

Prol. Paseo de la Reforma No. 600 - 201, Col. Santa Fé, 01210 México, D.F.
Telephones: + 52 (55) 2167-4300/4308, Fax: 52 (55) 2167-4302/4314.
www.fa.com.mx; info@fa.com.mx
www.strasburger.com; john.rogers@strasburger.com

the furnishing of medical services, which would be reserved to the Ministry; (iv) provide services in accordance with *prudent industry practices* as defined; (v) obtain all needed debt and equity financing for the project; (vi) during the construction of the hospital, comply with the design plans approved by the Ministry; and (vii) obtain all necessary environmental and other permits, with the Ministry making its best efforts to assist in that process. In the event of any dispute over the quality of the services provided by the Investor, which could potentially affect the payment of the fees payable by the Ministry, the dispute would be submitted to the Coordination Committee made up of representatives from both parties. Should the Committee be unable to resolve the dispute, it would be submitted to a Dispute Settlement Committee and failing that to arbitration in Mexico City under the rules of the International Chamber of Commerce.

Section 6.8 of the Services Contract provides that in connection with any financing obtained by the Investor for the project, the Ministry would commit itself to use its best efforts to provide in a timely manner the documentation that may be required by the creditors and would be usually delivered in transactions of a similar nature, under *international banking practices*. This will no doubt leave some room for interpretation but at least reflects awareness by the Ministry that normal project finance considerations must be taken into account in connection with the financing of the hospital. It should be noted that this section provides expressly that in the event of any refinancing of the project the Ministry shall share in 50% of any *financial benefit* obtained by the Investor with respect to the refinancing.

Finance issues

The nature of the project finance issues to be addressed will depend on the nature of the underlying PPS Service Contract. In some projects the Investor will have a significant involvement in all aspects of service delivery and in others only a minor role. The Investor's role will depend in part on whether the PPS fits into a traditional scheme such as those for operations and maintenance, design and build, turnkey operation, lease-purchase and so on. Whatever the structure, ordinarily the lenders or other creditors will be relying on project assets only and will not obtain guarantees from the shareholders of the Investor. This will mean that the lenders will seek maximum assurance that project revenues paid by the Entity to the Investor will be applied to the payment of the debt, and that in the event of a default they will be able to have recourse to the project assets and, if needed, to step into the shoes of the Investor and operate the project. In furtherance of such goals the lenders will seek to have project revenues assigned to them to pay down the debt, to take collateral security in the other project assets and to have the right to dispose of such assets if a payment default occurs.

The three project areas in which the government has chosen to focus initially are highways, health and education

As indicated above, Section 6.8 of the form of Services Contract for the hospital project indicates that the Ministry is aware that in a project financing in accordance with international standards, the lenders will require numerous documents to protect their position as creditors of the project. Section 18.2 *et seq* of the contract provides additional assurances along these lines, by specifying that the Ministry authorizes the Investor to assign or pledge any of its rights under the Services Contract (and any related construction contract) to its creditors to secure the payment of its obligations to them, provided that notice of any assignment or pledge is given to the Ministry along with a copy of any the assignment or pledge document. Such an arrangement is in accordance with Article 46 of the Acquisitions Law, which expressly permits such security arrangements, which are often accomplished through transfers of project assets to a guaranty trust for the benefit of the lenders. The Ministry also agrees in Section 18.5 that, before exercising any of its rights as a result of an Event of Default under Part Nineteen of the Services Contract, it will give written notice of its intent to exercise those rights and allow an opportunity to attempt to cure the default. Secured lenders would then be able to exercise their rights with respect to the Services Contract including the designation of a new manager of the hospital, subject to the Ministry's approval. This reflects awareness of the lenders' desire for step-in rights in the event of any default.

A tool of progress

While it seems too early to determine whether PPS contracts can be the basis for international project finance transactions as traditionally structured, the PPS rules are encouraging and the form of PPS services contract to be used in the Bajío hospital transaction seems to contain provisions of the type that could be used to protect creditors' rights in such transactions. Further analysis will be needed before firm conclusions can be reached in this regard.

As in all infrastructure projects undertaken by the private sector, before investors will commit to participate in a project they have to consider many issues apart from the strictly legal and financial concerns, including the partner selection process, the allocation of risks among the private sector parties, selection of managers and supervisors, determination of the means to assure service quality, and so on. But, of course, without firm legal structures many of these other elements may be rendered moot. In any event, the effort that the Mexican government has put into developing the PPS contract structures, and its evident awareness of some of the concerns that project lenders may have, are encouraging signs that the PPS concept is on its way to becoming a useful tool in the promotion of solutions to the many social and economic challenges facing the government of Mexico. ■