"Project Financing Power Plants in Mexico"

Asmita Banerjee Bhattacharya

Faculty of Law

McGill University, Montreal

November 2002

A thesis submitted to the Faculty of Graduate and Postdoctoral Studies in partial fulfilment of the requirements of the degree of Master of Laws.

Your file Votre référence
ISBN: 0-612-88108-3
Our file Notre référence
ISBN: 0-612-88108-3

Abstract

Project finance is a debt finance and risk allocation technique. In Mexico, contracts of this nature mostly arise as a result of a government procurement process. In such projects, there is a limited amount of freedom for the negotiation of the contractual terms and conditions.

Contracts for the engineering, procurement and construction of power plants implemented under the project finance structure are subject to the ordinary law of contracts as opposed to the administrative law which may place the government in a stronger bargaining position. Regardless of the application of the private or administrative law the principle of autonomy of will may seem to be relegated to a secondary level in these transactions. Given this aspect it is interesting to evaluate what role the parties play in negotiating the contract in order to establish whether freedom of contract is a mere fiction in such transactions.

Le Résumé

Le financement des projets est une technique d'allocation de risques et du financement des dettes. Au Mexique, les contrats de cette nature surviennent principalement à la suite d'un processus d'acquisition du gouvernement. Dans ces projets, il existe une limite à la liberté dans la négociation des termes contractuels et des conditions.

Les contrats pour l'ingénierie, l'approvisionnement et la construction de centraux électriques rendus effectifs sous la structure de la finance du projet sont soumis à la loi ordinaire de contrats par opposition au droit administratif qui peut placer le gouvernement dans une plus forte position de négociation. Sans se soucier de l'application du droit civil ou du droit administratif, le principe d'autonomie peut paraître relégué à un second plan dans ces transactions. Etant donné cet aspect, il est intéressant d'évaluer quel rôle les parties jouent dans la négociation du contrat afin de savoir si la liberté de contrat est une simple fiction dans des telles transactions.

Table of Contents
Project Financing Power Plants in Mexico

Chapter 4

Freedom of Contract and Project Financing Power Plants in Mexico.

Acknowledgements

This project would not have been possible without the help of key individuals and institutions. I would like to sincerely thank the following individuals: Professor Lionel David Smith for his ongoing academic support and guidance in this project: Christine G. Atukoit-Malinga, Ofelia Chavez Tello, Juan Gonzalez Anduiza and Lynette Obare for their editorial, technical assistance and deep personal support. I would also like to extend my thanks and gratitude to all the professors and staff of the Faculty of Law at McGill University for their understanding and support. This project would not have been possible without the encouragement and enthusiasm of my family who have my deepest gratitude.

Project Financing Power Plants in Mexico.

Introduction

Project finance is a risk allocation technique that is not only of interest to people in the economic and financial sectors. It is also of importance to jurists due its corporate, commercial and contractual implications. Project finance has strict requirements and in order to attract this type of financing, a project needs to be carefully structured to ensure that all the parties' obligations are carefully negotiated. Due to such arrangement, lawyers play an important role in transactions of this nature. Moreover, a common denominator in project finance transactions is the fact that participants negotiate multiple and separate contracts which are linked together in transactional unity.[1] The documentation involved in a project finance transaction is of two kinds: the underlying documents that refer to the project itself, which includes the engineering, procurement, and construction of the infrastructure. The second documentation is related to the financial aspect of the transaction.[2] The challenge for lawyers is to conciliate both types of documents in the contract.

Despite its importance to jurists and practitioners, very little has been written about project finance by legal scholars and practioners. Given this situation, it may be interesting to proceed to examine the technique from the legal point of view, with the desire that this investigation serves to clarify some of the issues related to the existence of freedom of contract (or lack of it) in such transactions.

---

[1] Dugue, Christophe, "Dispute Resolutions in International Project Finance Transactions" (2001) 24 Fordham Int'l Law Journal 1371.
[2] Ibid.

In Mexico, the construction of generation, transmission and distribution facilities and the purchase of capacity and energy have traditionally been left to the Government. This aspect is slowly changing as the process of deregulation seeps through the system in matters related to the generation of electricity and transport of gas. Nevertheless, gradual deregulation does not necessarily translate into greater contractual freedom. According to the current legal framework, private players generating electricity have very little freedom to decide how to employ their capacity and energy. This is because, article 72 of the Electricity By-Law[3] (*"Reglamento de la Ley del Servicio Publico de Energía Eléctrica"*), stipulates that private entities generating electricity only have the following options: sale of the energy to the government, use of the energy for self supply, use of the energy in emergencies arising from an interruption in the service and exporting the energy. Contractual freedom becomes increasingly important given the projected deregulation. The statutory limitation of the persons who may purchase electricity directly from power producers may automatically have an impact on their bargaining powers and exert a certain amount of pressure on them to accept contractual terms and conditions that have been presented by the government. The only other option in the highly regulated monopoly that prevails today is the generation of energy for self-supply and export. Mexico is not planning to rush into an open market for electricity, instead the initiative for the deregulation of the electricity sector presented to the Mexican legislature on August 16, 2002 seeks to grant the independent power producers the possibility of selling energy directly to commercial and industrial users whose consumption of electricity exceeds 2,500

[3] Official Gazette *"Diario Oficial de la Federal"* (hereinafter D.O.) July 25, 1997.

MW hour.[4] This means that even under a scenario that contemplates gradual deregulation there would still be fetters in the market to ensure that electricity producers do not freely trade in electricity. This may be attributable in part to the fact that, public interest plays a huge role in contracts for the sale of capacity and energy. The state may choose to keep certain types of electricity prices low (residential rates) to the detriment of the independent power producer. The state's primary concern is to ensure that that society in general has access to the service, and the prices do not make the service inaccessible to the average consumer. On the other hand, economists may argue that it would be more effective to let the market establish the price and conditions of the service, this would promote competitivity and hence lower prices as businesses struggle to offer the best prices and conditions to their consumers.

At present, the purchase of capacity and energy is subject to the rules regulating government procurement even though the contracts that arise from the act are not necessarily subject to the administrative law of contracts. In Mexico, the law applicable to the agreements under the independent power producer model is the ordinary law of contract. This is in distinction to the administrative law of contracts which would be applicable if the generation of electricity by private companies were considered public service. The contracts for the purchase of capacity and energy and/or the building of power plants is not subject to the public law because in these contracts the State intervenes as if it were a private entity.[5] This distinction is important because the application of the

---

4

<http://www.cfe.gob.mx/www2/queescfe/notaqueescfe.asp?seccion=queescfe&seccion_id=2587&seccion_nombre=Iniciativa%20de%20reforma%20eléctrica> last accesed October 5, 2002.

5 Fraga, Gabino, *Derecho Administrativo* 9th ed. (Mexico: Editorial Porrua S.A. 1986) at 92.

administrative law of contracts may confer to the government the right to practically dictate the terms and conditions of the contract. Moreover, administrative law may entitle the government the right to have access to administrative remedies which would enable them to sanction a contractor without any need to obtain a resolution from the judicial authorities and to resile under certain conditions. This may be unacceptable to the project developers and lenders of a project who want assurance of repayment.

The purpose of this investigation is to determine the role freedom of contract plays in such transactions, especially given the existence of "*clauses exorbitantes*" and public policy concerns that are always looming in the background in matters related to energy and electricity which are crucial to the development of a country. In this context, the principle of *pacta sunt servanda* may be relegated to a secondary level, but at the same time the private participants who seek to invest their money in the project and use their expertise want to be in a position where they can effectively negotiate the contractual terms applicable to the project. Given the predominance of "*clauses exorbitantes*" which not only place the government in a stronger bargaining position but clearly enunciate that different rules are applicable to the parties to the agreement, contractual freedom may be deemed a mere fiction and the nature of the juridical act might be considered akin to a unilateral declaration of will or at best an adhesion contract. Freedom of contract seems to be losing relevance in the welfare state, yet autonomy of will still seems to be the central issue in agreements despite the limitations to contractual freedom. Given this prevailing tug of war between contractual freedom or lack of such freedom it would be important to analyze the importance of this term in project finance transactions and establish whether autonomy of

will is a mere fiction or a reality or whether the legal implications of the concept has evolved over time to become a mere shadow of what it once was.

An important factor that must not be lost from sight is the fact that in the case of government contracts it is not only the private entity's rights which are somehow fettered by the tender documents which are quite explicit as to the terms and conditions applicable to the tender. Nonetheless, the government is also somewhat constrained by the statutory provisions, policies and budgetary norms applicable to such projects. The issue then becomes establishing how to conciliate public and private interests in such projects

The thesis will analyse some of the important issues that arise in project finance. Chapter one defines what project finance is, indicating the manner in which it differs from traditional corporate finance, parties involved in typical project finance transactions and the principal ways in which it may be financed.

Chapter two proceeds to establish why project finance is increasingly important for Mexico, the evolution from a statist to a neoliberal model. Chapter two also refers to the need for good faith dealings and lawful use of discretion in project finance.

Chapter three defines the way the public procurement process operates and the manner in which the winning tenderer is selected. This chapter also refers to "*clauses exorbitantes*" during the bidding process and evaluates whether contracts that derived from government procurement are adhesion contracts.

Electricity and energy are always regarded as prioritary sectors in any economy. This is because such resources are critical to the development of any country. As a result, there is need to compromise and to reach an understanding between the private and public sectors so that the relationship has some governmental characteristics despite the fact that it is a relationship between private parties. In this context of ideas chapter four deals with the public- private aspect of project finance, and the hurdles that have to be overcome in deregulating an industry that has been the object of a monopoly in accordance with the Mexican Constitution.

The thesis deals with project finance as it is implemented in accordance with the legal framework in Mexico, but would be illustrative of the most recent trends in project financing in the developing world. In Mexico the legislation allowing project financing of power plants has undergone extensive changes in the recent years. It has allowed private ownership of generating plants, something that was unheard of a decade ago. This is as a result of protectionist barriers that had been erected to limit foreign investment (in the name of sovereignty) and give the state control of strategic areas including electricity generation, oil, mines and railroads among others. The question to be answered in the course of this investigation is: Does the new framework give private participants leeway to negotiate contractual provisions? or is the public interest so overwhelming that there is little or no room for contractual freedom?

Project Financing Power Plants in Mexico

Project Finance - General Principles

Chapter 1

This chapter describes the manner in which project finance transactions are implemented in the world with a focus on Mexico. The information contained here seeks to increase awareness of the role freedom of contract plays in project finance transactions, and the possible existing limitations to such freedom. This chapter also indicates what project finance is, the reason why it became increasingly popular and the differences between this technique and traditional corporate finance.

Given the legal framework in effect in Mexico, the public and private dichotomy acquires special relevance; this is due to the fact that under usual circumstances contracts that are a result of government procurement for public works are governed by the administrative law of contracts as opposed to the civil law of contracts. This is not always the case; under certain conditions the ordinary law of contract is applicable to contracts that are a result of administrative acts. Regardless of the application of the administrative law or the civil law of contract, at first glance there seems to be very little room for the freedom of contract in such transactions. However, this may not be true given the fact that an invitation to tender is regarded as a mere offer to negotiate. The question that we shall attempt to answer in the course of this investigation is: What is the role played by the parties in establishing the terms and conditions applicable to the project?

I. General Concept of Project Finance

Project finance is a debt finance and risk allocation technique that involves the raising of funds to finance a particular "economic unit"[1], in which the developers of a particular project look primarily to the cash flows and the revenues that particular project shall produce as the source of funds to service their loans and to provide a return on the capital invested in the project. In other words project finance refers generally to revenue generating facilities.[2] In this context, a project developer is someone who supplies capital to the project.[3] Due to these characteristics, project finance usually involves financing large-scale projects on the long-term[4], because time is required for the lenders to be reimbursed from the expected cash flows of the project.

Project finance has long been in existence for the implementation of infrastructure projects. Some authors mention that project finance can be traced to the twelfth century when the British Crown negotiated with Frescobaldi (an Italian merchant of that time) a loan for the development of the Devon silver mines[5]. This transaction was a predecessor to what is known in our times as a production payment

---

[1] Nevitt, Peter K., *Project Financing*, 5th ed. (London: Euromoney Publications, 1989) at 3.
[2] Finnerty, John D., *Project Financing, Asset Based Financial Engineering* (New York: John Wiley and Sons, Inc, 1996) at 2.
[3] Nevitt, Peter K., *Project Financing, supra* note 1 at 3.
[4] Long term credit refers to credit for any duration longer than five years as per Ziegel, Jacob S., Geva, Benjamin & Cuming, R.C.C., *Secured Transactions in Personal Property, Suretyships and Insolvency* vol. III. 3rd ed. (Toronto: Emond Montgomery, 1995) at 5.
[5] Finnerty, John D., *Project Financing, Asset Based Financial Engineering, supra* note 2 at 4,5.

loan[6]. In modern times the best-known examples of project financing are the construction of the Suez Canal by the *Compagnie Universelle du Canal de Suez* and the construction of the Panama Canal.[7] The financing of the Suez Canal in 1858 was the world's first infrastructure project finance transaction.[8] In recent years well-known projects such as Eurodisneyland, Trans Alaska Pipeline System and the Eurotunnel have been financed under this structure.

In a project financing structure, obtaining the initial loans for the development of the project is not dependent on the credit support of the project developers or the value of the project *per se*, but on the profits the project would be capable of producing.[9] Despite this, close attention is paid by the lenders to the project developer and host government in order to determine its prospects of getting repaid in case the project encounters difficulties. The technique is used to arrange a loan to the developer's benefit, but at the same time avoids providing the financers of the project with access to the developer's assets in the case of poor project performance or inability to begin operation by a certain date or any other similar circumstances.[10] Due to the benefits of project finance with respect to risk allocation, the technique has gained increasing popularity in recent years because it alleviates investment risk and

---

[6] Buljevich, Esteban C., Park, Yoon S., *Project Financing and the International Financial Markets* (Boston : Klewer Academic Publishers 1999) at 266 states that a production payment agreement refers to a financing structure in which the lender purchases beforehand an undivided share in the in the production of a project during the operating period, instead of paying for the loan itself.

[7] Ibid at 86.

[8] Lang, Larry, *Project Finance in Asia* (Hague: Elsevier, 1998) at 1.

[9] Benoit, Philippe, *Project Financing at the World Bank.*, World Bank Technical Paper No. 312 (Washington D.C.: The World Bank 1997) at 16.

[10] Nevitt, Peter K., *Project Financing, supra* note 1 at 3.

provides an alternate way of implementing a project based on its own projected performance given the scarcity of financial resources.[11]

The project finance structure is generally centred on the viability of the project. This is because the project has no operating history at the time of its initial debt financing. The creditworthiness of the project is dependent on the project's anticipated profitability and indirect credit support provided by third parties. Special emphasis is placed on a particular project's technical and economical feasibility. Technical feasibility implies that the technology used in a particular project must be tested. The project must be feasible in the scale contemplated and it should not exceed its estimated financing cost. Economic feasibility refers to two different aspects: the solvency of the project developer and the possibility of concluding the project in the terms proposed without a significant cash shortfall.

II. The Parties in Project Finance.

Since this investigation is about contractual freedom and project finance, we shall begin by designating the parties who intervene in such transactions and the roles that they play. This enunciation seeks to assist us in understanding the role that public and private participants are expected to play in project finance and to establish who is the offeror and the offeree in such transactions.

The parties who intervene in most project finance transactions are:

---

[11] Finnerty, John D., *Project Financing*, *supra* note 2 at 236.

a) The host government.

In project financing transactions for power plants the government intervenes as the offeree in the construction contract. This is because the government publishes an invitation to tender in which it establishes the terms and conditions under which it is willing to enter into a contract with the other party. The invitation to tender is regarded as a mere offer to negotiate. The submission of a tender is considered an offer, which becomes a binding contract if accepted by the government.[12]

The term government has different meanings; first of all it may be used to designate the person or persons responsible for directing the destination of a nation in a particular point in time. Secondly, it could refer to the person or persons in the executive branch of the government as opposed to the legislative and judicial branch.[13] In the present investigation the term government is used to designate the executive branch of administration. In Mexico in accordance with the Federal Public Administration Law[14] (*"Ley Orgánica de la Administración Pública Federal"*) public administration can either be: "centralized" or "parastate". "Centralized" refers to all the Secretaries of State and Ministries. Under a presidential regime the Secretaries of State do not have a separate legal personality and are accountable both individually and collectively through the office of the President of the Republic. The other branch

---

[12] *Kawneer Co. v. Bank of Canada* (1982), 40 O.R. (2d) 275 at 283.
[13] Vincent, Andrew, *Theories of the State* (Oxford : Basil Blackwell Ltd. 1989) at 29.
[14] Article 90 of the Mexican Constitution (*"Constitución Política de los Estados Unidos Mexicanos"*) D.O. February 5, 1917.

of public administration is known as "parastate" and this term refers to entities which function like public corporations, have separate legal patrimony and personality, and can contract in their own name.[15]

Both the centralized and parastate heads of administration play a role in the project financing of power plants. In the first instance, the Minister of Energy establishes the guidelines, priorities of the energy sector, and the projections for demand of electricity. The public tenders for the implementation of the projects are in turn conducted by *"Comisión Federal de Electricidad"* (hereinafter CFE), which is a parastate entity of the Mexican government. CFE is not an entity that has attributions to enforce public policy, and should be held accountable to the public[16]; instead it acts as a private corporation. This distinction is important because actions of public corporations are judicially reviewable when they have powers of a public law character; it follows that since CFE does not have the jurisdiction to enforce public policy its acts are not subject to judicial review.

b) The project developer.

The project developer is selected in accordance with the procedure designated in the bidding guidelines and is the entity responsible for implementing the projects in accordance with the terms and conditions set forth in the bidding guidelines. All the

---

[15] Federal Law Related to Public Administration (*"Ley Orgánica de la Administración Pública Federal"*) D.O. December 29, 1976.
[16] Gellhorn, Ernest., Levin, Ronald M., *Administrative Law and Process in a Nutshell,* 4th ed.(St. Paul, Minn., West Publishing Co.) at 71.

participants in the public tender are technically offerors, who submit offers in response to the invitation to tender. The project developer is the winner of the award in the bidding process. Once the winning tenderer is selected and notified of the result of the process, it is presumed that there is *animus contrahendi* between the parties.[17] The announcement of the winning bidder marks the time when the offer meets that acceptance and there is an "*accord de volontés*", which leads to the formation of a contract given the lack of the consideration doctrine in most civil law jurisdictions.[18] Despite the existence of the *animus contrahendi* and the "*accord de volontés*" given the fact that government contracts are formal as opposed to consensual, the contract does not emerge unless and until the parties subscribe the written agreement.

c) Third parties.

With regard to third parties to a contract, Mexican law adopts the principle *res inter alios acta aliis neque nocere neque prodesse protest*[19], which means that contracts only take effect between the contracting parties.[20] Contracts do not impose any burdens on third parties and only benefit them in accordance with article 1868 of the Mexican Civil Code. The provision mentioned acknowledges that contracts may contain stipulations in favour of third parties. The law also recognises that contractual stipulations in favour of a third party create a right in such person to demand the

---

[17] Fridman, G.H.L., *The Law of Contract in Canada*, 3rd ed. (Toronto : Carswell 1994) at 26.
[18] Delebecque, Philippe, Pansier, Frédéric-Jêrome, *Droit des Obligations*, 2nd ed. (Paris: Litec 1998) at 16.
[19] Gutiérrez y González, Ernesto, *Derecho de las Obligaciones*, 6th ed. (Mexico City: Editorial Cajica S.A. 1987) at 489.
[20] Ibid.

performance promised by the promisor. Translated to project finance what this means is that if a contract entered into by the project developer and a third party confers certain benefits to the government, the government shall be in a position to seek the fulfilment of such promises and the enforcement of such provisions in its personal capacity and not as an agent of the project developer. Contractual stipulations in favour of third parties may also confer benefits to lenders and subcontractors involved in the project.

An additional aspect that must be taken into account while referring to obligations of third parties to a contract is the existence of the *Poenam Ipse Promiserit* Pact or Porte-Fort pact, which is an exception to the principle that enunciates that contracts only have an effect on the contracting parties. The *Poenam Ipse Promiserit* Pact in essence allows a contract to have an effect on a third party to the contract, as long as one of the parties to the agreement is under the obligation to obtain the consent of a third party for the execution of a judicial act and a penalty is stipulated for non compliance. The Porte- Fort pact is a principle of Roman law that has survived to our times and a variant of this promise is contemplated in article 1841 of the Mexican Civil Code, second paragraph. This Porte-Fort promise is important in project finance transactions since the project developer is required to assume the responsibility for the non-compliance or deficiencies of suppliers, subcontractors, operators, agents and lenders. The Porte-Fort pact is of special importance to the lenders who derive substantial rights from the contract entered into between the host government and the project developer for the implementation of the projects. Among

other rights lenders usually have rights to step in and fulfil the contractual obligations in case of non-compliance by the project developer and attach the project's assets in case of default.

Third parties who play important roles in project finance transactions for power plants are:

Subcontractors who participate in the engineering, procurement and construction of the project. Initially the project's developer assumes responsibility for any deficiencies in the services provided by the subcontractors.[21]

Suppliers to provide the project company with the materials required for the implementation of projects. The suppliers play an important role because they provide the project developer with the primary equipment required for the construction of the power plants and are under the obligation to ensure that the equipment is functioning correctly.

Operators to operate and give maintenance to the project facilities, especially in the case of IPP's. The existence and designation of operators is optional, the project developer can be responsible for the operation of the project. If the developer wants to pass this responsibility on to a third party CFE's approval must be obtained.

---

[21] Keyes, Noel W., *Government Contracts in a Nutshell* (St. Paul, Minn: West Publishing Co. 1989) at 67.

Lenders are a key figure in project finance, due to the amount of capital required to construct large infrastructure projects. In project finance transactions, the loans are usually syndicated loans with the intervention of multilateral lending institutions and commercial banks. Given this aspect, it is important to implement an intercreditor agreement, which may include the different classes of lenders. The implementation of the intercreditor agreement may serve as a useful instrument for accelerating the maturity of the loans, for establishing loss sharing or coordinating foreclosure of any collateral security for the benefit of the lenders.[22]

III. Contractual Models used in Project Finance.

In Mexico the principal models that have been used in project finance transactions are the: Independent Power Producer (IPP), Build, Lease, Transfer (BLT). Build, Own, Operate, (BOO) and its variant Build, Own, Operate, Transfer (BOOT) have seldom been used in Mexico for power plants and are the preferred modality while dealing with coal handling units, or gas pipelines.[23]

a) Independent Power Producer (hereinafter "IPP").- In the IPP model an independent power producer proceeds to construct a power plant and enters into an agreement for the sale/purchase of electrical energy associated with the guaranteed net capacity. The term guaranteed net capacity refers to the fact that the power plant has to meet a certain capacity requirement which is determined in accordance with

[22] Nevitt, Peter K., Project Financing, *supra* note 1 at 48-51.
[23] < http://www.energia.gob.mx/wb/distribuidor.jsp?seccion=74> last accessed October 5, 2002.

the forecasts for projected demand for electricity in a certain area, although the producer is at liberty to install excess capacity which it may sell to a third party or for self use. [24]

The principal difference between the IPP and the BLT models as implemented under the legal framework of Mexico is that under the IPP model the project developer is *de facto* the owner of the power plant. In the BLT model the project developer's responsibilities are limited to the engineering, construction and procurement of the plant, and CFE is responsible for the operation of the plant. Under the IPP model the producer enters into an agreement for the sale of capacity and energy with CFE.

The IPP model was introduced in anticipation of an open market for electricity and energy, where generation is left to private participants. Under this structure the project developer is the owner of the plant and CFE only has the obligation to buy the plant in case of governmental *force majeure.* Governmental *force majeure* refers to risks, which are associated with the country itself. These risks include but are not limited to situations such as changes in the legal framework which would render exceedingly onerous for private players to stay in the market. Governmental *force majeure* also includes events such as wars and insurrections in Mexico, sabotage and embargoes. The government assumes the risk associated with these events not only because it is in a better position to assume such risks but also because there is always

---

[24] Ibid.

the suspicion that the government may in some way contribute to the risks while delineating the policies the country is to follow.[25]

On the other hand, ordinary *force majeure* refers to events that are beyond the control of the parties, which are not attributable to their negligence and cannot be avoided by the parties due diligence.[26] In this scenario, CFE has the option to buy the power plants and all the related assets of the project in case of ordinary force *majeure*. The project's developer bears the commercial risk related to the transaction during the life of the project. Another important risk factor is related to the fuel supply during the tests and operation of the plant and site selection. In most of the projects that have been implemented under this structure the site has been selected by CFE although the developer has the option to propose an optional site. This has never occurred in reality because if the developer were to propose a site, the risks inherent to water supply for the cooling the turbines, adequacy of the site, proximity to fuel supply, and obtaining certain permits including the environmental impact permit would shift to the developer. The payment structure in this model is composed of capacity and energy charges. The capacity charges are fixed in nature but the energy charges are subject to variation.[27]

b) Build, Lease, Transfer Project (hereinafter "BLT").- Under this model a developer selected according to the criteria set forth in the public tender documents, is

---

25 <http://www.cfe.gob.mx/www2/queescfe/notaqueescfe.asp?seccion=queescfe&seccion_id=2271&seccion_nombre=Generaci%F3n> last accessed October 5, 2002.

26 Galindo Garfias, Ignacio, *Derecho Civil,* 20th ed. (Mexico City : Editorial Porrua 2000) at 271.

responsible for the engineering, procurement and construction of a power plant. The responsibility of the developer is limited to the construction of the plant in accordance with the project specifications and financing of the plants on a long term basis. The developer does not intervene in any way during the operation of the plant and begins to receive payment for the plant after the tests have been successfully completed and commercial operation has been attained.[28]

In a BLT transaction, the developer is responsible for the building of the project on a turnkey basis, hence is responsible for the engineering, procurement and construction of the project. In accordance with this structure the project's developer is under the obligation to attain commercial operation on a designated date. If the commercial operation date is attained as scheduled, and the tests are accomplished successfully, CFE is under the obligation to accept the plant and issue the acceptance certificate. After the issuance of the acceptance certificate, the operation of the plant passes to CFE. CFE is obligated to operate the plant in accordance with the developer's indications and commences periodic payments of the money owed for the plant on a hire-purchase basis. After the acceptance of the plant the payment is owed to the developer on a "hell or high water" basis, which means that the payment is due, come what may thus, CFE is obligated to make payments even if the operation of the plant were rendered impossible at a later date due to commercial, political or *force majeure* risks inherent to the project.[29]

---

[27] <http://www.energia.gob.mx/wb/distribuidor.jsp?seccion=142> last accessed October 5, 2002.
[28] Ibid.

In the near future the government would like to leave the project finance structure behind and progress to a simple power purchase agreement for the sale of capacity and energy.[30] Under a power purchase agreement the principal risks associated with the project would shift to the developer. The project developer would be responsible for project financing the generating plants and the contract for the sale of capacity and energy would have to be negotiated with a power pool (under a deregulated model not yet in effect) or with the government. Under this structure the buyer would only be required to pay for the energy effectively received at an interconnection point, being under no obligation to make payments for capacity and energy if no energy were received at such point. In terms of the law of contract, what this means is that very soon the parties may find themselves negotiating a simple agreement for the sale of a commodity instead of complex agreements for the engineering, procurement and construction of power plants.

IV. Advantages of Project Finance.

Project finance helps overcome the difficulty faced by governments in obtaining the money for infrastructure projects through limited public revenues, especially in developing countries where there is a pressing need for infrastructure projects and where an ailing economy may severely restrict the government's spending power.[31] Power plants are regarded as especially suited to project finance

---

[29] Ibid
[30] <http://www.energia.gob.mx> last accessed October 5, 2002.
[31] Bjerre, Carl S., *International Project Finance Selected Issues under Revised Article 9*, American Bankruptcy Journal, (1999) National Conference of Bankruptcy.

because there is a growing demand for the output given the increase in demand for power (6% annual growth in demand for electricity in Mexico[32]) and the tariffs paid by the users would cover the cost of the project. Otherwise lenders would shrink from financing projects that do not have favourable cash flows.

Financing projects under the project finance technique may be an advantage under certain circumstances because it provides a way of financing projects that may otherwise not be financeable. The reasons include the following features of project finance[33]:

i) Developers are allowed to finance a project without having their general assets exposed.

ii) Developers who do not have sufficient standing to borrow money on the basis of their general assets, and credit standing may be able to do so under a project finance structure.

Other advantages of project finance over traditional corporate finance is that the technique can increase the availability of finance. It reduces the overall risk of the project to an acceptable level by sharing the risks among the project participants.[34] In addition it assists in getting better financial conditions where the credit risk of the

---

[32] <http://200.23.166.206 :1030/publicaciones/secele.pdf> last accessed October 5, 2002.
[33] Benoit, Philippe, *Project Finance at the World Bank, supra* note 9 at 8, 9.
[34] IFC, Ahmed, Priscilla, Fang, Xinghai, *Project Financing in Developing Countries,*(Washington D.C. : International Finance Corporation 1999).

project is better than the credit standing of the developers, obtaining a better tax treatment to the project's advantage, and reducing the political risks surrounding the project.[35]

V. Overview of Project Finance Worldwide.

In North America the implementation of projects under the project finance scheme was given a boost in 1978, in USA after the enactment of the *Public Utility Regulatory Policy Act*, under which local electric utility companies are required to purchase all the electric output of qualified independent power producers under long term contracts. Under this scenario the price of electricity must equal the electric utility's "avoided cost" that is its marginal cost of generating electricity. In 1990 half of all the power production that came into commercial operation came from projects developed under the *Public Utility Regulatory Policy Act Regulations*.[36]

In the past two decades the number and scale of infrastructure projects that are project financeable in Europe and the USA has rapidly diminished, and fewer projects have needed project finance. As a result, banks that are looking for worthwhile projects to invest in, have been forced to look elsewhere for profitable projects, and have turned their attention to Latin America and Asia.[37]

---

[35] Buljevich, Esteban & Park, Yoon S., *Project Finance and the International Finance Markets*, *supra* note 6 at 121.
[36] Finnerty, John D., *Project Financing, Asset Based Financial Engineering*, *supra* note 2 at 5.
[37] Lang, Larry, *Project Finance in Asia*, *supra* note 8 at 1.

In developing countries the need for basic infrastructure is acute and there is a considerable shortage of public funds to devote to such projects. Under the circumstances, project financing is the most viable option by which the country can gain access to international capital. As such, it is regarded as an "appropriate mechanism to address constraints and concerns".[38] A survey conducted in 1993 by the World Bank[39] illustrates that nearly 150 private infrastructure projects had been carried out world-wide and half of these projects were made in developing countries. It has been stated that the rapid growth of project finance in developing countries during the past decade has been facilitated by the direct support from multilateral agencies such as the World Bank Group, the Interamerican Development Bank, Export-Import Banks of many countries and other similar institutions.

Project finance has also been facilitated in many developing countries that have "strengthened their macroeconomic management and liberalised their economic structures."[40] This led to increased investment and a strong demand for financing. The governments of developing countries, faced with the difficulty of procuring capital through traditional means to invest in infrastructure projects, have resorted to enacting legal frameworks that may facilitate investment in infrastructure projects and activities which were previously reserved to the state under the import substitution and protectionist model.

---

[38] Wallace, Don Jr., *Host Country Legislation a Necessary Condition*, (2001) 24 Fordham Int'l LJ 1396.
[39] Benoit, Philippe, *Project Finance at the World Bank, supra* note 9 At 4.
[40] Ahmed, Priscilla, Fang, Xinghai, *Project Finance in Developing Countries, supra* note 34 at 14.

Between 1994 and 1998, Asia received around 41 percent of the project finance volumes in developing countries followed by Latin America and the Caribbean, which received 31 percent.[41] Since 1998, Latin America has been attracting most of the capital destined for project finance and this is due in part to the Asian economic crisis and the fact that countries such as Mexico[42] were relatively untouched by the recession during this period. Latin America also made a faster recovery than Asia because by 1997-1998 inflation was declining and was at the single digit in most countries. Budget deficits had been curtailed, international reserves were high and debt profile had been strengthened because two thirds of the money invested consisted of foreign direct investment, which is less likely to flee in response to short term recessions.[43] During this period in Latin America, trade liberalisation was sustained despite economic difficulties. The policies reflected a trend to move away from the protectionist, statist model that had prevailed in the region a little more than a decade ago.[44]

Foreign direct investment in Mexico is on the rise since 1991, given Mexico's sustained economic recovery and trade liberalisation[45]. The Organisation for Economic Co-operation and Development (hereinafter OECD) statistics show that

---

[41] Ibid at 15.
[42] Horowitz, Shale, Heo, Uk, *Explaining Precrisis Policies and Postcrisis Responses: Coalitions and Institutions in East Asia, Latin America and Eastern Europe* (Lanham: Rowman and Littlefield Publishers, Inc.) at 3, 11.
[43] Herman, Barry ed. *Global Financial Turmoil and Reform, A United Nations Perspective* (Tokyo: The United Nations University Press 1999) at 5.
[44] Horowitz, Shale, Heo, Uk, ed. *The Political Economy of International Financial Crisis, supra* note 42 at 11.
[45] OECD, *Foreign Direct Investment, OECD Countries and Dynamic Economies of Asia and Latin America* (Paris : OECD Publications 1995).

since 1990, the largest flows of foreign direct investment in Latin America have gone to Mexico and Chile.[46]

The winners of public tenders for the construction of power plants in Mexico are mostly from countries with which Mexico has a free trade agreement. American firms such as Intergen, General Electric, ABB Energy Venture and AES are developers of combined cycle projects such as Samalayuca II (506 MW)* [47], Merida III (467.8 MW)*, Bajio (495 MW), Monterrey II (436.9 MW), Rosarito IV (489 MW). Canadian firms have also been involved in project financing power plants and gas pipelines in Mexico. Transalta Energy Corporation is presently involved in the implementation of two power plants Campeche (252.4 MW) and Chihuahua III (259 MW), Transcanada Pipelines is another Canadian corporation which has an extensive amount of experience in project financing in Mexico and was involved in the Yucatan Peninsula Gaspipeline project and Bajio gaspipeline project both of which were completed successfully and are now in commercial operation. The rest of the companies involved in project finance transactions come from Japan (Mitsubishi, Nisho Iwai and Nichimen Corporation), Spain (Iberdrola Energy, Abener Energy, and Union Fenosa) and France (EDF International and Alstom). Alstom[48] has been especially successful in special and alternate energy projects such as geothermal, hydroelectric and diesel projects.

---

[46] Ibid.
[47] * means that the power plant has attained commercial operation.
[48] Chicoasén Hydroelectric Power Plant, Las Tres Virgenes Geothermal Power Plant, San Carlos Diesel Power Plant.

A factor that reflects the confidence that the international community feels towards Mexico, is the fact that in most of these cases the foreign investor either participates alone (twelve combined cycle projects out of twenty)[49] or participates in a joint venture with other foreign companies (only one project, the Merida III combined cycle power plant has involved the participation of a Mexican company). The increasing presence of Spanish and French companies may also be explainable due to the fact that the legal framework in Mexico is somewhat akin to that prevailing in these countries, which somehow contributes to boosting investor confidence. The relationships with France and Spain are strengthened due to historical reasons, which include the colonial past and an effort to rule Mexico by France, these factors may act as an added incentive for investors.[50]As of February 23 and 24, 2000, Mexico is the signatory of a free trade agreement with the European Union. The decree approving the terms and conditions of the agreement was passed on June 6, 2000, but the agreement still has to be ratified by the Mexican Senate in order to have the status of Federal Legislation, according to the disposition set forth in article 135 of the Mexican Constitution. Regardless of the impact of the free trade agreement it would seem like the Spanish and French companies have succeeded in their quest for the Mexican energy market. In the medium term these companies may be in a much better bargaining position because the power plants that they own are strategically located at or close to the Mexico - U.S. border. This means that depending on the

[49] CFE annual report 2001 at <http://cfe.gob.mx/www2/noticia_...id=&seccion_id=1359&publicacion=50> last accessed October 5, 2002.

[50] EDF International is the owner of 4 plants (Saltillo, Rio Bravo II, Rio Bravo III and Rio Bravo IV) equalling 1732.5 MW of installed capacity. Iberdrola Energy is the owner of 3 plants (Monterrey III, Altamira III, IV and La Laguna II), which combined come to total installed capacity of 1975 MW.

supply, demand and favourable contractual terms, they may elect to sell energy on either side of the border. In the near future, as some of the players get stronger and deregulation erodes the barriers affecting energy trade these private entities may be soon find themselves in a stronger bargaining position. The role of the legal framework is to ensure that this does not have a negative impact on the average consumer in Mexico.

The importance of project finance is such that in July 2000 the United Nations Commission for International Trade Law (UNCITRAL) adopted a legislative guide for privately financed infrastructure projects. The guide deals with host country legislation, especially the issues that need to be contemplated in such legislation in order to attract investment and proceed with privately financed infrastructure projects.[51] Even though countries are under no obligation to pay heed to these guidelines, they nevertheless reflect the increasing need to have an adequate legal framework in countries where infrastructure projects are being constructed under the project finance model.

The implementation of legislative guides by UNCITRAL, also serves as a reminder that the needs and concerns of private and public participants need to be addressed in an equitable manner in order to ensure the success of the project. In this context, citing Lord Hewart's famous dictum in *R. v. Sussex Justices, ex p McCarthy,*

Union Fenosa is the owner of 3 plants (Hermosillo, Naco Nogales and Tuxpan III, IV), combined all these plants have an installed capacity of 1491 MW.

[51] Wallace, Don Jr. "*Host Country Legislation a Necessary Condition*", (2001) 24 Fordham Int'l LJ 1396.

it becomes of fundamental importance that "justice should not only be done, but should manifestly and undoubtedly be seen to be done."[52] Applied to project financing transactions what this principle means is that once the general public perceives that the procurement process and tender documents are just and fair, private participation in such public tenders is enhanced and the risks diminished.

If the needs of the private participants are not addressed in the contract, this has a noticeable impact on the financing costs of the project, rendering it more expensive for the government. The price of the project is the one aspect which the bidder has an unrestricted autonomy to decide and offer. If the projects where perceived to be risky and one sided the project would become more expensive. This is because the taking of risk has an implicit cost and contractual provisions that are deemed unclear, uncertain or downright unconscionable are translated into risk and hence affect the project's viability. The price offered in project finance transactions is not only a reflection of the costs associated with the project, but also voices the concerns that the bidders may have with respect to the project documents. In the end, this means that the issues the project developer may have with respect to the contractual documents may be expressed either during the periods designated during the tender process for clarifications, political lobbying to induce changes to the documents or ultimately in the price offered for the project.

Another factor that we cannot disregard in contracts of this nature is that private participants have access to channels to voice their concern. In 1996 in an

[52] [1924] 1 KB 256 at 259.

effort to enhance private participation in energy projects the Unit to Promote Private Investment (*"Unidad de Promoción de Inversiones"*) was created by the Ministry of Energy, this department seeks to address the issues that may affect private participants in energy projects.

The lack of fiscal resources to devote to projects of this nature may play a role in making the terms and conditions of the projects favourable to private investment because under these circumstances, the government may find it convenient to make the projects attractive to the private sector. To state that the private sector is defenceless and at the mercy of the government while negotiating contracts would be a fallacy. This is due to the fact that it is in the government's best interest to reach an agreement and the electricity producers may exercise a lot of pressure to have the contractual terms and conditions adjusted to their best interests. In fact, the accusation in terms of political unrest seems to be directed to stating that the government is making things to easy for private participants and this may eventually have repercussions on the public in general.

The only noticeable change between the contracts that are result of government procurement and other agreements entered into in accordance with the private law contracts, is the ability of the potential tenderer to make changes to the project documents. The rejection of terms and conditions contained in the bidding documents is not equivalent to a counter offer, where the other party is free to accept

or reject the terms and conditions of such offer.[53] Instead the rejection of such terms and conditions is considered non-compliance with the requirements set forth in the project guidelines. The potential tenderer is at liberty to refrain from submitting a bid if he or she feels that the terms and conditions contained in the tender documents are too harsh or unacceptable.

It cannot be denied that in matters related to electricity, there is an overwhelming need to abide the existing regulation in the field, and the terms and conditions contained in the tender documents are sometimes a result of public policy considerations. This is due to the fact that this regulation has an important social dimension, it seeks to ensure that the service in question is available to all and is not restricted or constrained in an arbitrary manner.[54] But the need for regulation in the matter does not mean that private interests have to be sacrificed for the benefit of the State.

VI. Risk Allocation, Deregulation and Contractual Freedom.

Project finance is essentially a risk allocation technique, and the regulation and deregulation in the energy sector basically has an impact on the risk allocation scheme. The enunciation of risks that are present in project finance transactions (under an essentially regulated model) helps us understand the concerns project

---

[53] Article 1810 of the *Mexican Civil Code*. D.O. June 26, 1932 (all references to the Mexican Civil Code are to the Civil Code of Mexico City or the Distrito Federal).
[54] Wade, William, Forsyth, Christopher, *Administrative Law,* 8th ed. (Oxford: Oxford University Press 2000) at 173.

participants may face while adhering to contracts for the engineering, procurement and construction of power plants.

Under a regulated model there are some risks that the government must absorb in order to make the project feasible and yet there are others that have been traditionally allocated to the private participants. Restructuring of the energy market means that private participants have a lot more say while negotiating the contractual provisions, but at the same time shall be required to absorb most of the risk related to construction and financing of the power plant. The contractual provisions must be adjusted in order to reflect this reality; under the deregulated structure it would be up to the producer to negotiate the agreements for the engineering, procurement and construction of the plant.

Restructuring of the electricity industry means leaving behind the traditional market structure in which a vertically integrated, state owned monopoly is responsible for the generation, transmission and distribution of electricity. In the area of generation, under the traditional structure the lowest costs could be achieved by building large-scale power plants. In transmission and distribution this structure effectively tackled problems related to wheeling[55], and the construction of competing transmission and distribution facilities to service the same market.

Restructuring also means the vertically integrated monopolies shall be reorganised into separate generation, transmission and distribution service companies.

Restructuring is also expected to increase the competitive pressure, and lower regulatory expenses. Under this structure the role of the government will pass from being the principal player responsible for generating, distributing and supplying electricity to an entity in charge of supervising the system.

Risk is a central issue in project finance, and that restructuring of the electricity industry will modify this structure that prevails in the traditional vertically integrated monopoly, that is responsible for generating, transmitting and distributing energy. Under the structure prevailing at present in Mexico, IPP's play a limited role of selling energy to the state controlled monopoly. This aspect may soon change if privatisation occurs.

Different types of risks concur in project finance transactions; Benoit[56] classifies the risks inherent to project finance as: Project risks and debtor credit risks.

Project risks are risks that are directly associated with the project are critical to its success. Project risks may be classified as follows:

a) Political and monetary risks, which are inherent to the host country where the project shall be located and this includes changes in law, inconvertible or non-transferable currency, risk of sudden devaluation if the cost of the project is paid in a currency different from the currency in which the loans are

[55] The transmission of power belonging to one utility through another utility's transmission grid.
[56] Benoit, Philippe, *Project Finance at the World Bank, supra* note 9 at 12.

incurred, expropriation, and political violence, commercial embargoes or war.[57] Political risks are external in nature and out of the control of the parties involved in the project.

b) Commercial and operation risks associated with the project, which refer to construction, operation, fuel and market risks. Commercial risks can be long or short term depending on whether it is a construction risk (short term) or operation risk (long term). Commercial risks may be internal or external to the project.

c) *Force majure* risks that are not within the control of the project participants, and which are external in nature.

On the other hand debtor credit risks refers to the project developer and its chances of getting financing. This is contingent upon the rating the company may have, its past credit record, administrative costs and its financial condition among other factors.

The distinction between commercial, political, economic and *force majure* risk is of primary importance in project finance because the nature of the technique involves the shifting of risks to the person who is in a better position to bear that risk. For instance the commercial risk inherent to the project is usually borne by the project

[57] Mauel, John G., "*Common Contractual Risk Allocations in International Power Projects*" (1996) 1996 Colum. Bus. L. Rev. 37.

developer, who is responsible for making the arrangements for the engineering, procurement and construction of the project, and getting the financing required for the project.

Some of the principal contractual provisions are drafted on the basis of the risk allocation scheme. The enunciation of the events of default and the cure periods is reflective of the allocation of risk among the parties. Despite this aspect in practice it would seem like the project developer has little or no say as to what constitutes events of default given the fact that the contract may be considered akin to an adhesion contract, where the autonomy of will is relegated to the background. Nevertheless, this does not mean that project developers may be forced to assume onerous obligations against their will, because they always have the price mechanism in which they can ultimately translate all their fears. An unfair allocation of risks would also be to the government's detriment and eventually have an adverse impact on the user of the service. This is because the additional risk may have an impact the cost of electricity rendering it more expensive. This means that the pressure to reach an acceptable deal is on both sides.

VII. Legal Principles applicable to Project Financing Transactions for the Construction of Power Plants.

In a typical project finance transaction a revenue-generating project that is technically, environmentally and financially sound is proposed for construction, operation and maintenance in a certain host country[58].

As is the case in some civil law jurisdictions in Mexico, the administrative law is applicable to contracts that deal with any aspect of public service. The generation and distribution of electricity is considered a public service. In the case of electricity, in order to ensure that there is some scope for the negotiation of contractual terms, the Electricity Law[59] (*"Ley del Servicio Público de Energía Electrica"*) expressly stipulates in its article 3, that the generation of energy by independent power producers shall be deemed not to be public service (emphasis added). This distinction is crucial. If the generation of energy by independent power producers were considered public service, the contract would by virtue of law, be an administrative contract. This means that the contract would not only be subject to special rules and specific procedures of administrative law with the exclusion of principles of civil and commercial law, but also in case of any dispute between the parties, the administrative tribunal (*"Tribunal de lo Contencioso Administrativo"*) would have the jurisdiction to resolve the dispute and conciliate the public and private interests, as opposed to the civil courts.

Administrative contracts tend to severely restrict the bargaining power of the parties, this is because they are subject to specific policies, rules and regulations in effect. Administrative contracts also contain stipulations known as "*clauses exorbitantes*" which may give the public authority broad powers of supervision, direction, and in some cases unilateral cancellation of the contract.[60] The

---

[58] Finnerty, John D., *Project Financing, Asset Based Financial Engineering, supra* note 2 at 4.
[59] D.O. December 23, 1992.
[60] Schuck, Peter H., *Foundations of Administrative Law,* (New York : Oxford University Press 1994) at 357.

categorisation of a contract as administrative would have the impact of severely curtailing the parties' bargaining power and negotiation of contractual provisions to the extent that any agreement for the purchase of capacity and energy would be a mere adhesion contract, whose terms and conditions are unilaterally dictated by one of the parties. The inclusion of "*clauses exorbitantes*" in contracts for the project financing of power plants would render the financing of the project practically impossible because in project finance transactions the lenders require assurance that the project shall be repaid. The right to unilaterally cancel a contract due to policy considerations would be essentially unacceptable under the project finance context.

Another aspect that must be taken into consideration is that contracts for the engineering, procurement and construction of power plants are usually long term and during this period it is evident that there may be substantial changes in the presidential cabinet and the executive power in general. There is therefore a considerable amount of risk that the administrative policy shall change over the years. This means that there is an overwhelming need to exclude the so called "*clauses exorbitantes*" from the contractual provisions.

Under this context, given the fact that contracts for the purchase of capacity and energy fall under the realm of the private law of contracts, there is a certain leeway for contractual freedom. This is attributable in part due to the fact that the

government is deemed by virtue of law to be acting as a private entity and not within its public sphere.[61]

Despite the above, given the technical and specialised nature of the contracts in question, and notwithstanding the fact that at least in theory the ordinary law of contracts is applicable, in practice the contractual freedom of the parties may be subsidiary to the use of standardised tender documents and procedures.[62] This generally means that the freedom of contract is reduced to a minimum in such transactions, especially in a heavily regulated environment.

Another constraint that subsists in contracts of this nature, is the fact that governments do not enjoy the same freedom natural persons have to enter into contracts.[63] Natural persons have an unlimited freedom to enter into contracts, whereas the government is constrained in its choice of contractual provisions given the question of subject matter jurisdiction, the statutory framework and the policies in effect. This is because in accordance with the doctrine of *ultra vires,* an entity acting under statutory power can only act within the limits indicated in law.[64] This is because it is presumed that the recipient of statutory power has been chosen for its particular characteristics and should act within the confinements of subject and territorial jurisdiction.[65] Applied to project finance it means that even CFE and the Minister of Energy are restricted in their capacity to enter into contracts, for instance

---

[61] Fraga, Gabino, *Derecho Administrativo,* (Mexico City : Editorial Porrua S.A. 1986) at 91.
[62] Turpin, Colin, *Government Procurement and Contracts,* (London: Longman 1989) at ix.
[63] Arrowsmith, Sue, *Government Procurement and Judicial Review,* (Toronto : Carswell 1988) at 111.
[64] Foulkes, David, *Administrative Law,* 8th ed. (London : Butterworths 1995) at 198.

there are statutory limitations that affect hydroelectric or geothermal plants in aspects related to water supply and environmental issues and hence impact the object of the contract. These issues must be taken into account while negotiating contracts for the project finance of power plants.

Authority to contract in certain cases may also be subject to the approval of an entity, which is hierarchically superior or a higher-ranking officer in the department.[66] This basically means that even if it were the intention of the government to allow private participants to play a major role in the negotiation of contracts of this nature, this may not be possible given the regulatory framework in effect. Experience tells us that promises which are intended to be binding but are only a mere expression of the government's intention do not fetter its future executive actions.[67] So any promises that the government may make at present in order to permit private participants to play a greater role in contract negotiations may not be binding unless actual changes are implemented to the regulatory framework and contractual documents.

---

[65] Ibid at 207.
[66] Turpin Colin, *Government Procurement and Contracts*, *supra* note 62 at 95.

VIII. Differences between Project Finance and Traditional Corporate Finance.

Project finance is different from traditional finance in that in a traditional finance scheme the primary source of repayment is the project's borrower backed by his entire balance sheet and not the cash flows generated by the project alone. In traditional finance although creditors are wary of financing white elephants and projects that are doomed to failure and assure themselves of the viability of the project in question, an important role is played by the sponsor whose business reputation and balance sheet are determinative in getting financial closing. Depending on these factors, in a conventional financing the creditors of a project will have considerable assurance that they will be repaid even if the project fails as long as the company owning the project remains financially viable.[68] The lenders may request to have a *stand-by* letter of credit or a performance bond that they would be able to call upon in case the company's financial situation changes to its detriment. In conventional finance the failure of a project does not usually affect the lenders, but this does not mean that lenders would be immune from incurring in huge losses in case of bankruptcy. Even if they were secured creditors, they would also have to incur costs in order to recover the monies owed to them and levy execution on the debtor's assets.[69]. In a project finance structure the failure of a project usually implies

---

[67] Ibid at 88.
[68] Ahmed, Priscilla, Xinghai, Fang, *Project Financing in Developing Countries, supra* note 34 at 34.
[69] Ziegel, Jacob S., Geva, Benjamin & Cuming R.C.C., *Secured Transactions in Personal Property Suretyships and Insolvency,* 3rd ed. (Toronto : Emond Montgomery Publications Ltd. 1995) at 5.

that lenders and investors can expect significant losses unless the project is bailed out[70].

Project financing is certainly not to be regarded as a panacea because it is only applicable to a limited range of capital intensive projects It is considerably more expensive than conventional asset based financing due to the greater amount of time and manpower resources required.

In this chapter we strove to establish what the project finance technique is all about, and the principal legal issues that come up in this context. The information contained in this chapter seeks to pave the way to discuss the public- private dichotomy, which arises in project finance.

[70] For instance the Eurotunnel Project suffered considerable delays and losses, due to the fact that it did not attain commercial operation on the projected date it was scheduled to open in May 1993, but was formally opened to freight service on May 6, 1994. It was originally expected to cost 4.8 billion pounds but ended up costing 10.5 billion, more than the double original estimate. It also suffered huge losses due to competition from ferry operators who cut fares, and aggressive airline advertising that resulted in huge losses, but despite this due to the visibility of the project and its importance the European financial community feels that the project should continue to operate.(Finnerty, John D. *Project Financing*. *supra* note 2 at 310-314).

Chapter 2

Private Investment and use of Discretion in Mexico

I. Paving the way to reform in the energy sector in Mexico.

In order to be in a position to understand the role freedom of contract plays in the project financing of power plants, it is important to establish why this technique became increasingly popular in Mexico. This aspect is especially relevant given the patrimonial aspect of the administrative rule in Latin America. In the past, the Spanish colonies in America were treated as the personal property of the ruler and this tendency seems to have survived to our times. To date, politics is concentrated in the office and the person of the President, who is responsible for dictating the path the country is to follow. Even though Constitutionally, Mexico is a federation in practice it is a centralist state where the power is concentrated at the top and even the most routine and minor decisions require the approval of the person at the top of the hierarchy.[71] Applied to project finance what this essentially means is that the person at the top makes the most of the decisions with regard to the project documents, the type of project, the buy out clauses and the amount of supervision that is required.

The patriarchal nature of Mexican politics undoubtedly has an impact in issues related to administrative discretion, which in turn may affect the tender procedure and documentation. Unlawful use of discretion enables public officials to

"overreach, to discriminate invidiously, to subordinate public interests to private ones"[72] Historically the government has had a broad discretion to address issues and at present more controls are being put in place to ensure that the discretion is subordinate to the rule of law and the principle of supremacy of the law.

The description of the political panorama that Mexico has faced over the last century also helps us to understand why it would be unacceptable, given the context of political and economic instability and the unlawful use of discretion enjoyed by the government in the past, to have IPP contracts governed by the administrative law of contract, as opposed to the private law of contracts.

II. The Rule of Law and the Role of Discretion in Mexican Law and Politics.

In theory, Mexico has always strictly adhered to the principle of rule of law. In practice the Executive power embodied in the person of the President of the Republic enjoyed a broad discretion to dictate the norms the country was to follow. Before the year 2000, leadership was intimately linked to a political party, the "*Partido Revolucionario Institucional*" or PRI which had been in power for an uninterrupted 70 years[73]. In accordance with the Mexican Constitution there is no such thing as presidential re-election[74] and the president elected holds office for six

---

[71] Schuck, Peter H., *Foundations of Administrative Law, supra* note 60 at 336.
[72] Ibid at 155.
[73] Heath, Jonathan, *Mexico and the Sexenio Crisis, Presidential Succesions and Economic Crises in Modern Mexico* (Washington D.C.: The CSIS Press 1999) at XV.
[74] Article 83 D.O. February 5, 1917.

years and this is known as a "*sexenio*" in Spanish. During this period the President's power is absolute and in practice he has the power to dictate the policies the country is to follow.

The principle of rule of law seeks to impose fetters on the Government's exercise of power over individuals, curbing arbitrariness and encouraging the application of general rules.[75] The law is the norm that establishes limitations on the government's use of discretion. Discretion may be manifested in a variety of ways; for instance it may be used while allocating government contracts to private participants. It may even be used while deciding compensation in case of nationalisation and expropriation. Unlawful use of discretion may also be used to assign contracts to political cronies by recurring to direct allocation or restricted invitation instead of an open bid process which would ensure transparency and competiveness. Due to the impact that unlawful use of discretion may have in the selection of the winning bidder in the public tender process and the possible constraints to contractual freedom in this context, it is imperative to establish mechanisms for judicial review and control.

Contractually, unlawful use of discretion shifts the bargaining power to one of the parties in a transaction, and limits the contractual freedom of the other. Due to this it is imperative that such use of discretion should be identified and curbed by legal mechanisms such as certiorari, mandamus or prohibition depending on the circumstances of the particular case. It should be noted that the public law remedies

mentioned are not available in case of a breach of a contract by a public entity and in case of the government's default the project developer has to seek civil remedies such as damages or an injunction.[76]

In Mexican law differentiates between two types of administrative acts: acts that are obligatory or compulsory and discretionary acts.[77] Obligatory or compulsory acts arise as the direct result of the letter of the law, which specifies how and when the authority with jurisdiction should act. In the case of discretionary acts, the law enables the authority to decide when and how it must act or refrain from acting. In government procurement both types of acts are present, and usually there is no clear demarcation between the two. In the case of compulsory or obligatory acts, the role of the courts in judicial review is relatively simple as it is restricted to establishing whether an administrative act conforms to the parameters established in the legislation. Discretionary acts pose a little more of a problem because the existence of unlawful use of discretion may only be a question of perception and it is not always a clear cut solution. Yet the need to curb and eventually eradicate unlawful use of discretion is great.

Under a scenario where there is little scope to limit the unlawful use of discretion by the government, there is a fair amount risk that there will be few or no offers or that the offers will be very expensive. This is because potential tenderers may be fearful of the fact that the government may not honour its commitment, under

---

[75] Shapiro, Ian, **ed.** *The Rule of Law* (New York : New York University Press 1994) at 148,149.
[76] Arrowsmith, Sue *Government Procurement and Judicial Review, supra* note 63 at 19.

this circumstance the risks of not recovering the investment would be high. Unlawful use of discretion also means that there is an impending risk of the government unilaterally declaring a moratorium of its foreign debt instead of renegotiating or working towards other possible solutions, and this would have a decided impact on projects of this nature. These conditions may affect contractual freedom in the tender process because unlawful use of discretion may translate into rigid or more lax contractual terms. This is to disadvantage of the producer of electricity or to the consumers in general, depending on the trend that is being followed and contributes nothing to fair contractual terms. [78] In Mexican politics unlawful use of discretion was a common phenomenon before the 1990's. This is in part attributable to the fact that during his or her term in office the acts of the president are above public scrutiny, because the he or she has immunity during this period. There was no fear of offending the electorate and losing the next elections because the party in power had no competition (it had been in power for 70 years). These factors may have had an impact on the delay in the implementation of restrictions on the unlawful use of discretion.

After the 1990's the PRI lost popularity and no longer had a majority in Congress and its actions became increasingly questioned by opposition parties[79]. Under the circumstances fiscal stimulation was no longer perceived as an option and the public increasingly voiced the need to restrict unlawful use of discretion. Due to

---

[77] Fraga, Gabino, *Derecho Administrativo*, *supra* note 61 at 150.
[78] Furmston, M.P. **ed.** *Cheshire, Fifoot & Furmston's Law of Contract,* 13th ed. (London: Butterworths 1996) at 18.

this, the implementation of project finance structures in energy projects seemed like a viable solution. The loss of popularity of the "ruling party" also meant that there was a growing need to design proper constraints and legal devices in order to ensure the proper control and confinement of the unlawful use of discretionary power.[80] The mechanisms instituted to confine discretionary powers of statutory authorities contribute to acknowledging private interests and addressing concerns that private entities may have. In this context the legal maxim *Audi Alteram Partem*, became increasingly important since this meant that the other side must be heard. In order to voice its concerns a private party is entitled to appeal the decision to the Administrative Tribunals. But *Audi Alteram Partem* does not ensure that the decision taken by a statutory authority will be revoked, since the court that is responsible for hearing the case is at the liberty to confer little or no importance to the evidence presented by the parties.[81] The principle of *Audi Alteram Partem* in project finance transactions seeks to ensure that the legitimate expectations of the parties are protected.

In this sphere of administrative law the issue is not that the wide discretionary power enjoyed by the government be eliminated, but that the law establish mechanisms in order to control its exercise.[82] It is acknowledged that a certain amount of discretion is required in order to ensure fairness, yet the government is bound to abide by the rules it has set for its own conduct in accordance with the

---

[79] Horowitz, Shale. Heo, Uk, **eds.** *The Political Economy of International Financial Crisis, supra* note 42 at 190, 191.
[80] Schuck, Peter, *Foundations of Administrative Law, supra* note 60 at 165.
[81] Yardley, D.C.M., *Principles of Administrative Law* (London: Butterworths 1991) *at* 94.

principle *legem patere quam ipse fecisti* (the government must follow the rules it has created) and act in accordance with the mandate set forth in the legal norm. Typically in civil law jurisdictions there may be very little room for discretion, this is because in principle all the law is found in the codification.[83] In Mexico the Civil Code expressly limits the use of discretion since the principle of rule of law embodied in article 19 of the Code states that legal controversies shall be decided in strict adherence to the letter of law and its juridical interpretation. Strict adherence to the letter of law necessarily means that interpretation is only an option if the provision is unclear and use of discretion is viable only if there is a lacuna or the law expressly allows the use of discretion.

In Mexico, there is a growing need to reconcile the interests of the public and private sphere. In this context, discretion is referred to not as something arbitrary which follows the will of the ruler but as "...a science or understanding to discern between falsity and truth, between wrong and right, between shadows and substance, between equity and colourable glosses and pretences, and not to do according to their wills and private affections, for as one saith, *talis discretio discretionem confundit.*"[84]

III. Growing need for Private Participation in Projects.

Private financing of power plants has become crucial in Mexico in recent years, due to the fiscal deficit and a steady increase in the demand for electricity. CFE

---

[82] Wade, William.& Forsyth, Christopher, *Administrative Law, supra* note 54 at 353.
[83] Barry, Nicholas, *The French Law of Contract. Contract Law Today. Anglo- French Comparisons.* (Oxford : Oxford University Press 1989) at 8.
[84] *Rooke's Case* (1598) 5 Co. Rep. 99b.

estimates that the annual national demand for electricity will grow at a rate of 6.0 % annually for the period from 1998 to 2007 and this demand will still be greater for the industrialised regions in Baja California (7.7%) and Yucatan Peninsula (6.8%) and an increase of 6.6 % in the Northeast. In order to satisfy the increase in demand the government estimates that 19,270 MW of additional capacity will be required by the year 2007.[85]

The above mentioned data serves to illustrate why there is an increase in project finance transactions and private investment in the different sectors of economy in Mexico. The shortage of funds that the country may directly invest in such projects is tied to the debt crisis and political changes in the system which paved the way to privatisation of the different sectors of economy, and addressed the important need to change from an import substitution, protectionist model where the state played a leading role in the economy to a neoliberal model. In the late 1970's and early 1980's Mexico faced an increasing difficulty in servicing its external debt and obtaining new foreign credits and faced imminent insolvency in the international financial markets. [86]

The sovereign debt crisis in Mexico began formally on 22nd August 1982, when Mexico declared a moratorium on its debt payments and announced that it could no longer service its external debt. A sovereign debt crisis arises where a country's net inflow of foreign exchange is insufficient to meet its external debt

[85] < http://www.cre.gob.mx/publica/informe01/informe_2001.pdf> last accessed October 5, 2002..

burden.[87] The inevitable consequence of the debt crisis was to attempt to organise the debts in the hope that by extending their maturities they could be fitted into the sovereign debt service capacity. The debt crisis made the government aware that it no longer had the resources to invest directly in the economy and it became imperative to look for other sources of financing to promote infrastructure projects in the country.

The debt crisis had dire consequences in the medium and long run.[88] Before the 1980's there was a high degree of state intervention in the economy; protectionist policies prevailing in the 1940-1960 period were perceived as templating the foundation for Mexico's extraordinary economic performance.[89] During this period the Mexican economy operated under an import substitution model, the emphasis was towards industrialisation at all costs, and this policy contributed to creating a large industrial capacity that was under-utilised and consequently resulted in high unemployment.[90]

Although it is impossible to pinpoint the period when Mexico's recurring crises began, many analysts allege that the crisis commenced in 1968. During that year the crisis had nothing to do with currency devaluation or a balance of

---

[86] MacCallum, Robert Kenneth, *Sovereign Debt Restructuring. The Rights and Duties of Commercial Banks*.(Washington D.C.: The World Bank 1997).
[87] Sarkar, Rumu, *Development Law and International Finance* (London : Kluwer Law, 1999) at 98, 99.
[88] Neiman Auerbach, Nancy, *States, Banks and Markets Mexico's Path to a Financial Liberalization in Comparative Perspective.* (Oxford USA, Westview Press 2001) at 23.
[89] Ibid at 30-33.
[90] Kessler, Timothy, *Global Capital and National Politics Reforming Mexico's Financial System, System* (Westport, Connecticut, Praeger Publishers 1999) at 28-31.

payments[91]. It was a political and social crisis set in motion by students protesting against an extremely brutal police force and the authoritarian nature of Presidentialism[92]. This movement, known as the "Tlatelolco Movement" was violently suppressed by the government, but it contributed to opening people's eyes and since then society has played an increasingly greater role in questioning the political system. What this means in essence is the broad discretion traditionally enjoyed by the government was gradually constrained as the public became increasingly critical of the government's actions.

From April 1954 to August 1976 Mexico's exchange rate was fixed at 12.50 pesos to the dollar.[93] In August 1971 the Nixon administration unilaterally dismantled the Bretton Woods exchange rate system, putting an end to nearly 30 years of stable and predictable international currency convertibility. In addition, in an attempt to transfer the costs of its own macroeconomic adjustment onto its international trading partners, the United States imposed a ten percent surcharge on all imports. The imposition of this surcharge had dire effects for the Mexican economy, which has traditionally regarded the United States at its principal trading partner, with up to 80% of the exports are destined to that country.[94] By the end of President Lopez Portillo's term in office in 1982, the international economic environment that had made borrowing easy and inexpensive was transformed. Interest rates began to soar and this made it impossible for Mexico to meet its foreign debt obligations. In addition to all

---

[91] Heath, Jonathan, *Mexico and the Sexenio Curse., Presidential Successions and Economic Crises in Modern Mexico, supra* note 73 at 18.
[92] Ibid.
[93] Heath, Jonathan. *Mexico and the Sexenio Curse, supra* note 73 at 19.

the above-mentioned factors the price of oil also began to fall and this placed Mexico in a particularly tight spot, because Mexico is an exporter of crude oil. After the debt crisis in the 1980's, Mexico agreed to follow the International Monetary Fund's (IMF) policy guidelines in exchange for new loan guarantees. These policy considerations included the privatisation of state owned companies, liberalisation of trade and deregulation of commerce and investment and severe cuts in government expenditure.[95]

Implementing liberalisation to the different sectors in the Mexican economy began during the term in office of President Miguel de la Madrid, who was faced with a virtually insolvent government as international lending had been cut off before he took office. De la Madrid elevated state planning to a constitutional level by reform in article 25 of the Mexican Constitution, a paragraph copied almost literally from the Cuban Constitution which gave the state almost unlimited power to interfere in all spheres of private economic activity.[96] This translated into increasing control from the state in all spheres of the economy. In this context there was little leeway for the public private debate given the fact that the state dictated most of the terms applicable to economic activity.

In Latin America it was said that the loans made during the 1970's had been made for specific projects but had been diverted to become what in the jargon is

---

[94] <secofi.gob.mx> last accessed on October 5, 2002.
[95] Neiman Auerbach, Nancy, *States, Banks and Markets Mexico's Path to a Financial Liberalization in Comparative Perspective, supra* note 88 at 37.

known as balance of payment loans, that is loans to pay off previous loans.[97] Thus it can be deduced that funds that were originally destined to be applied to infrastructure projects that might have in some way contributed to the development of the country, were not thus employed making the need for such projects acute.

The second major crisis in Mexico was the devaluation of the Mexican peso in 1994-1995 which triggered another recession in the country. The devaluation was the result of political turmoil in Mexico in 1994, insufficient reserves and artificially maintaining the exchange rate in order to preserve party credibility before elections. As a result of the crisis foreign investment inflows into the country slowed down and the country's official reserves declined causing a flight of investment. Much of the money invested was pulled out of the Mexican economy and the stock exchange. The peso lost 45 percent of its acquisitive power within that year.[98]

Due to the crisis that hit the economy it was acknowledged that the import substitution and statist model was no longer an option and liberalisation and privatisation were needed to promote growth.

Given the scenario of recurring financial crisis and a growing need for infrastructure, it became necessary to adopt the project finance technique. Project finance is the preferred mechanism for financing power plants because under a

---

[96] Kessler, Timothy P., *Global Capital and National Politics Reforming Mexico's Financial System, supra* note 90 at 51.
[97] Baker, James C., *Foreign Direct Investment in Less Developed Countries the Role of ICSID and MIGA* (Westport CO: Quorum Books 1996) at 11.

project finance model the lenders and investors are not required to assume the political risk involved in such transactions; this is important because most developing countries have poor credit ratings and unstable economic and political systems. Lenders and investors are also not required to assess the commercial risk because the special purpose company formed to develop a specific project is typically formed for the sole purpose of the individual project and has no performance or credit rating. If the project company defaults its obligations to lenders and investors, there is recourse against the project company's assets but not against the assets of the developer that formed the project company. The lender's risk assessment therefore focuses on the commercial, technical and political risks of the project rather then the creditworthiness of the power utility and the host nation.[99]

Project finance is relatively new to Mexico; in fact this mechanism only became possible during the era of President Carlos Salinas de Gortari in the 1990's, whose administration was perceived to be the most aggressive promoter of economic liberalisation in Mexican history[100]. The Salinas administration considered that the transformation of the Mexican economy was the key to implementing economic growth and due to this perception the government resorted to cut public spending, and succeeded in turning a huge deficit into a moderate surplus.

---

[98] Ibid at 11, 12.
[99] Stelwagan, William., *"Financing Private Energy Projects in the Third World"* (1996) 37. Catholic Law 45.

IV. The Evolution of Private Participation in Power Generation.

Before the 1990's the Mexican economy was highly statist in nature. The government was the rector of the economy and controlled it to "commanding heights"[101]. This feature also has its basis in the Constitution which contemplates in articles 27 and 28 that minerals in the ground, oil, electricity generation, railroads are strategic areas of the economy and are reserved to the state. The provisions cited were considered fundamental to preserving the country's sovereignty. It was presumed that if a (foreign) private entity had control of such strategic sectors of the economy, the country would be rendered vulnerable. This sentiment was echoed in Article 602, Annex 602. 3 of the North American Free Trade Agreement, which states that the following activities are deemed strategic and are reserved to the Mexican state:

a) The exploration and exploitation of crude oil and natural gas; basic petrochemicals, their feedstock and pipelines;

b) Foreign trade, transportation, storage and distribution of crude oil, natural and artificial gas, basic petrochemicals.

---

[100] Kessler, Timothy P. *Global Capital and National Politics Reforming Mexico's Financial System, supra* note 90 at 8.

[101] Weintraub, Sidney, *Financial Decision Making in Mexico* (Pittsburgh: University of Pittsburgh Press, 2000) at 16,17.

c) The supply of electricity as a public service in Mexico including the generation, transmission, transformation, distribution and the sale of electricity, excluding production of own use, co-generation and independent power production.

d) The exploration, exploitation and processing of radioactive minerals and generation of nuclear energy.

Under a highly regulated statist model the government usually dictates the terms and conditions applicable to the transactions. The contracts are subject to the administrative law of contract. The "*clauses exorbitantes*" which the government is entitled to exercise in order to uphold the public interest are the dominant characteristics of the law of contract under this model and there is little or no room for contractual freedom of contract. The statist model slowly gave way to a more liberal model that sought to encourage private participation in all sectors of society.

As a result of the debt crisis and bank nationalisation in the 1980's, there was an increasing opposition to populism and presidentialism. By the time President Salinas came into office PRI's credibility was shattered, and he was further faced with accusations of electoral fraud. Salinas considered that PRI's electoral vulnerability was based on a record of economic failures. His strategy to put an end to what seemed to be an intermittent crisis was to "move beyond adjustment and radically accelerate the market transition"[102] President Salinas engineered the

[102] Kessler, Timothy P., *Global Capital and National Politics Reforming Mexico's Financial System* *supra* note 90 at 82-83.

transformation of the Mexican economic model, implemented bold economic reforms, reformed laws that had erected artificial barriers to foreign investment, and in general implemented widespread privatisation and induced foreign investment in Mexico. During this era the government cut public spending by massive privatisation of state owned industries, reformed legislation that restricted foreign investment in Mexico, eliminated barriers to free trade and pursued regional integration.[103]

The extensive and indiscriminate deregulation implemented in different sectors of the economy during the term in office of President Carlos Salinas de Gortari, enhanced the role that private participants had played so far in the generation of electricity, and opened the doors to contractual freedom. The first changes were introduced to the Electricity Law ("*Ley del Servicio Publico de Energia Electrica*") on December 23, 1992. At this time article 36 Bis was added to the Electricity Law, allowing private ownership of generating facilities and imposing on CFE the obligation to conduct a public tender to determine which bidder fulfilled the selection criteria contemplated in the bidding guidelines and offered the best (capacity and/or energy) charge (es) and was reliable. In accordance with the reforms introduced in the Electricity Law and its respective by-laws private participation was permitted in the electricity sector in accordance with the following models:

a) Production for Own Use.- In accordance with article 101 of the Electricity By Laws ("*Reglamento de la Ley del Servicio Público de Energía Electrica*") and Annex 602.3 of the North American Free Trade Agreement, this particular type of private

[103] Ibid at 28-36.

investment refers to generation of electricity for personal use as long as it is for the entrepreneur's own need and is supplied by plants specifically destined to meet such demand. In accordance to this model electricity generated in excess of such needs must be sold to CFE.

b) Cogeneration.- Refers to the use of secondary energy to produce electricity, indirect production of electricity using thermal energy not employed in another industrial process or using fuels produced in other industrial processes.

c) Independent Power Production.- This structure has gained widespread use and popularity, it is the most commonly used structure for project financing generating plants in Mexico today. This structure refers to capacity and energy from a plant with a production capacity of over 30MW. A project developer may acquire, establish or operate an electricity generating facility under this modality in Mexico; this model also contemplates the cross border sale of electricity.

d) Small Scale Production.- Refers to generation of up to 30 MW either for sale to CFE or export. If the small-scale production is used to supply a small rural or agricultural community the production should not exceed 1 MW in accordance with article 111 of the Electricity By-Law.

e) Production of electricity for export in the case of cogeneration, independent production and/or small-scale production.

Project finance is an important technique in financing generating plants because it provides a mechanism for providing financial resources, using the application of efficient management skills and innovative technology which generally promotes efficiency and injects capital into a sector that is indispensable for the economic growth of a nation, without having to devote public funds to it. This factor is of primary importance given that the generation and distribution of electricity are indispensable to develop and industrialise a nation. Other elements that must concur in order for there to be progress are a consensus on a country's long term goals. This is known in financial terms as strategic planning and refers to a long term program that establishes the goals that the country has to pursue in order to attain progress[104]. In this context of ideas in order to promote the development of Mexico the government has proceeded to establish in the National Development Plan (*"Plan Nacional de Desarrollo"*) which enunciates the strategy that the government must adopt in order to promote development, the need to increase the installed capacity in power plants and to promote private investment and eventually deregulation in the areas of generation and distribution of natural gas.

In the electricity sector there is an impending risk of deregulation that would give the producers of electricity the right to sell to large consumers of electricity and in the future there may even be an open market for energy. A proposal that would enable the private participants to play a greater role requires Constitutional amendment in

[104] OECD, Douglas, Roger, *The Role of Governments in the Economy, Privatization in Asia, Europe and Latin America* (Paris: OECD 1996).

Mexico, the Mexican Constitution is relatively inflexible in nature, this means that it cannot be amended through an ordinary legislative process, but calls for a special procedure with a very high level of societal consensus before an amendment is permitted.[105] In fact, article 135 of the Mexican Constitution enunciates that in order for a constitutional amendment to take place it has to be approved by two thirds of the Congress and the majority of state legislatures. When the proposal for the privatisation of power generation was presented there was widespread opposition in society and the PRI, which had been the party in power, no longer had the supermajority in congress and hence the proposal was not approved. In order to make the risk of deregulation manageable, the power purchase agreement deems that there is an event of default if CFE is wound up, consolidated or merged with another entity or in any way ceases to perform all or a substantial part its current activities, and in this case the developer may force CFE to purchase the power plant and accessory equipment. The privatisation of electricity would be a very unpopular move for the government, and due to this the initiative for amending articles 27 and 28 of the Mexican Constitution presented to the legislature on August 16, 2002, reiterates and acknowledges that that State is the only entity entrusted with the obligation of providing this public service.[106] Private players may have a longer wait then expected in order to be permitted to play a greater role in the electricity market.

---

[105] Sánchez Bringas, Enrique, *Derecho Constitucional,* 6th ed. (Mexico City: Editorial Porrúa 2001) at 236.

[106] <http://www.cfe.gob.mx/www2/queescfe/notaqueescfe.asp?seccion=queescfe&seccion_id=2587&seccion_nombre=Iniciativa%20de%20reforma%20eléctrica> last accessed October 5, 2002.

In Mexico as we have seen, the project financing structures primarily employed to implement the projects have been the Independent Power Producer (IPP)[107] structure and the build lease and transfer (BLT) structure. [108] Even at present when so many projects are under way under the project finance technique there is a pressing need to make changes in the electricity sector. One of the areas where changes are impending is the area of the tariff charged for the public service. A distorted tariff structure is an obstacle to private investment of power plants in most developing countries, which is often subsidised by the government for residential purposes, and where industries are required to pay higher rates in order to permit the subsidisation of the residential sector.[109] This distorted tariff structure and the added aspect of currency risk inherent to the tariffs (as they are charged and calculated in pesos in Mexico and there is always an impending risk of devaluation) contributes to adding risk to the transaction and may have an impact in the financing cost of the project. The tariff structure may eventually have to change if the projects are to be self-funding as the concept of project finance dictates and lenders are to have assurance that the project will be able to pay for itself in the designated period.

---

[107] Merida III (484 MW) plant was the first plant in Mexico built under this structure at present this model is increasingly popular and the following combined cycle projects are under construction Rio Bravo III (495 MW), Hermosillo (250 MW), Saltillo (247 MW) and Bajio (495 MW). More projects are being subject to a public tender in accordance with this structure.

[108] So far the following power plants have been constructed or under construction in accordance with the BLT model are: Combined cycle Monterrey II (484.20 MW), combined cycle Chihuahua Stage I (434.65) MW, Geothermal plant Cerro Prieto IV (100 MW), Diesel Power Plant Puerto San Carlos (39.37 MW), Geothermal plant Tres Virgenes (10.9 MW) and combined cycle Rosarito III Units 8 and 9 (541 MW) and the Guerrero Negro Diesel Plant (10 MW).

[109] Hansen, John., Nanivska, Vira., *Economic Growth with Equity, Ukranian Perspectives*, World Bank Discussion Paper No. 407 (Washington D.C. : The International Bank for Reconstruction and Development, The World Bank 1999).

The changes in the energy sector in this field cannot be regarded as a privatisation despite the reforms to the legal framework allowing private participation and ownership of generating facilities. This is because privatisation would entail the transfer of government owned assets and production facilities to private hands, which has not been contemplated. Instead the trend is directed towards deregulation as a mechanism for increasing the efficiency of the system, introducing competition and ensuring that the system meets the demand for electricity in the medium and long run. In the medium term Mexico plans to join its North American counterparts in the trend to restructure electricity markets, leaving behind the traditional model under which a single utility performed the functions of generating, transmitting and distributing electricity, allowing competition in the generation sector. Under this model the state would be responsible for the transmission and distribution of electricity. This is because these activities are the object of a natural monopoly, which is required to ensure the safety and reliability of the delivery service. Under this model the private participants would be required to play a greater role in the electricity market and this would certainly enhance their negotiating power *vis a vis* the government. Despite the course deregulation seems to be taking in Mexico, it is acknowledged that if the proposed amendment allowing greater private participation is approved by the legislature it will enhance the power producer's possibilities within the Mexican market and their bargaining power *vis a vis* the (the public and private) purchasers of energy.

In this chapter we have seen that the unlawful use of discretion contributes to increasing the tension between public and private participants. There is a constant need to seek ways to curtail the unlawful use of discretion in such transactions in order to safeguard the private participants' interests in the project. The examination of the issues presented in this chapter is relevant because an investigation about contractual freedom and the role parties play in negotiating contracts would be incomplete without exposing why the projects are needed. This may in turn reveal which contracting party is more vulnerable if the contracts are delayed or do not go through. Regardless of existence of the legal norms that essentially seek to level the playing field for the parties the economic factors also play a central role. The need for the projects or the contracts may render a party vulnerable if the projects are an absolute necessity for the development of a country. The government might cede to the unreasonable demands of the private participants it there are few enterprises with the capacity to undertake projects of this nature. On the other hand, sometimes private participants who are eager to access markets worldwide to enhance revenues and avoid bankruptcy and insolvency may go to great lenghts to compromise and do business.

Chapter 3

Government Procurement and Project Finance

I. Legal Framework Applicable to Government Procurement in Mexico

Since this investigation is essentially about contracts that are the result of a procurement process it is important to establish what procurement is and the procedure that is normally used in Mexico. Government procurement is the method by which the government acquires goods or services from private industry,[110] and seeks to ensure that there is a certain control in the use of public funds.[111]The purpose of procurement is to ensure that the government gets the best possible value for money; this principle is known as the "best value principle"[112]. Procurement also seeks to ensure transparency and curb discretion promoting the fair treatment of contractors.

Power plants and electricity like any other goods are purchased by the government in observance of procurement process. The winning tenderer is selected in accordance with the procedure established in the Electricity Law[113] ("*Ley del Servicio Público de Energía Electrica*")in the case of IPP's and the procedure established in the Law of Public Works and Services Related to the Same[114] (*"Ley de Obras Públicas y Servicios Relacionados a las Mismas"*) in the case of BLT's. The

---

[110] Turpin, Colin, *Government Procurement and Contracts, supra* note 62 at 124.
[111] Ibid at 50.
[112] Arrowsmith, Sue, *Government Procurement and Judicial Review, supra* note 63 at 59.
[113] D.O. December 22, 1975.
[114] D.O. January 4, 2000.

procurement process is also governed by the rules set forth in Chapter 10 of the North American Free Trade Agreement.

CFE is a decentralized public corporation of the Mexican Government, which is responsible for the generation, supply, distribution and transmission of energy. In accordance with the current regulatory framework, CFE conducts the open or public tenders under supervision from the Ministry of Energy (*"Secretaría de Energía"*), the Energy Regulatory Commission (*"Comisión Reguladora de Energía"*) and the Comptroller's office (*"Secretaría de la Contraloría y Desarrollo Administrativo"*).[115]

II. Open Tenders and Selective Tenders.

Open tenders are a competitive process in which all the companies which fulfil the requirements set forth in the invitation to tender may participate.[116] The invitation to tender is to the public at large and in Mexico it is published in the Official Gazette ("*Diario Oficial de la Federación*"). Open tenders are the norm in projects for the construction of power plants.[117] This is because it is the most convenient process to obtain the best value[118] and it is also a mechanism that deters corruption and unlawful use of discretion.

---

[115] This is in accordance with article 45 of the Federal Public Administration Law (*Ley Orgánica de la Administración Publica Federal*) D.O. May 14, 1986.
[116] Article 30 of the Law of Public Works and Services Related to the Same ("*Ley de Obras Públicas y Servicios Relacionados con las Mismas*") D.O. January 4, 2000.
[117] Electricity By-Law ("*Reglamento de la Ley del Servicio Público de Energía Electrica*") article 124. D.O. July 25, 1997.
[118] Turpin, Colin, *Government Procurement & Contracts, supra* note 62 at 132.

Selective tendering differs from open tenders in that the Government chooses the companies it wants to invite offers from.[119] The tender documents are available to only those designated entities. In a selective tendering the government is in the position to use its discretion to designate who may participate in such projects. The selection of participants in a selective tendering may have a restrictive impact, because some participants who are in a position to satisfy the requirements set forth in the tendering documents may be excluded from participating. Selective tenders are used where a competitive tender would not be advisable given the fact that there are very few suppliers of a particular good or when it will be indispensable to save time given an imminent emergency in the electricity system due to lack of capacity and energy to meet demands.

In recent times selective tenders, also known as tenders by restricted invitation, have only been conducted in contracts for the import of electricity. This is because the government saves time and money by investigating beforehand who has the excess capacity and energy that it may be willing to sell.

In an open tender process the participants who fulfil the requirements set forth in the invitation to tender and the bidding documents have the option of registering to participate in the tender. The bidding documents are a set of technical, financial and legal documents, which establish in detail the specifications that have to be met.[120]

---

[119] Article 41 of the Law of Public Works and Services Related to the Same ("*Ley de Obras Públicas y Servicios Relacionados con las Mismas*") D.O. January 4, 2000.

[120] In accordance with Article 33 of the Law of Public Works and Services Related to the Same ("*Ley de Obras Públicas y Servicios Relacionados con las Mismas*") D.O. January 4, 2000.

All the bids submitted in response to an open tender must comply with the requirements set forth in the bidding guidelines or else they may be subject to disqualification.

There has to be a minimum period between the date of the publication of the invitation to tender and the day for the presentation of the bids in order to give the potential tenderers time to prepare their bids.[121] During this period potential participants may ask questions with respect to the project documents and suggest clarifications and/or amendments to the same. CFE responds to all these questions, and the answers are available to all those participants who have registered for that particular tender. This is in order to avoid giving some participants information that may confer advantages to them while excluding others. In order to ensure transparency and fairness in the tendering process the same information must be available to all the participants.

After the participants have been notified of the answers to their questions and clarifications a new version of the documents, incorporating the changes that have been made to the technical, contractual and economic documents, may be made available to them. The changes may be introduced to the project document at CFE's own initiative or in response to the questions received in the bidding process. This stage of the process is one of the ways in which potential tenderers may influence changes to the project documents and it is a regular part of the bidding process. During this period the changes introduced to the tender documents are subject to the

government's discretion, as the government decides on the basis of the questions received which amendments are to be included in the project documents. The government is of course bound by principles such as fairness and natural justice, which are conditions that govern the exercise of statutory power, but these concepts are flexible and their content is subject to the nature of the inquiry and the consequences for the individuals involved[122].

During the tendering process the contractual documentation included in the tendering documents may be akin to "letters of intent" which is a method for establishing the basic terms and conditions applicable to an agreement and the basis for further negotiations. "Letters of intent" also seek to ensure that parties are committed at least to the point of being prepared to acknowledge that the terms are the principles of the deal.[123] The basic distinction between the tender documents and the "letters of intent" is that negotiation is an important aspect of letters of intent, whereas the tender documents may only be the object of negotiation where the tendering entity has indicated its intent to negotiate or when it appears from the evaluation that not one of the tenders is the most advantageous in terms of the specific evaluation and criteria set forth in the bidding documents.[124] Negotiation is restricted in the public tender process because it may translate into unfairness given the fact that aggressive negotiators may have the ability to influence the selection criteria set forth in the bidding guidelines to the detriment of the other participants.

---

[121] NAFTA Article 1012.
[122] Burgoa, Ignacio, *El Juicio de Amparo*, 38th ed. (Mexico City: Editorial Porrúa 2001) at 26, 27.
[123] Swan, John & Reiter, Barry J. *Contracts, Cases, Notes and Materials*, 4th ed. (Toronto: Emond Montgomery 1991) at 319.

Changes introduced to the tender documents should have essentially the same impact on all the participants otherwise the purpose of the bid process may be distorted.

In practice changes introduced to the tender documents are also motivated by factors that are external to the bidding process such as political lobbying. In fact in times of economic recession and unfavourable trade balance the minimum national content in the public tenders have been raised to the limits established in NAFTA in order to give the local industry the opportunity of participating in the tenders.

III. The Tender Process

On the day designated for the reception of the tenders the bidders are required to submit their offers in two separate sealed envelopes marked "Technical Bid" and "Economical Bid"[125]. This is in order to ensure that the tenderers comply with the requirements of technical experience and financial capacity before the actual price element is evaluated. The tenderers must present a demand guarantee or *stand-by* letter of credit in order to ensure that their offer will remain open for the period designated in the tender documents (usually 180 days for IPP's in accordance with the Electricity Law) and they shall not withdraw their offer. The effect of the guarantee is two fold first of all it makes it easy for the State to collect in case of the tenderer's breach. The guarantee also acts a deterrent for tenderers to withdraw their offers before the evaluation of the bids or subscription of the contract for the

---

[124] NAFTA Article 1014.
[125] Article 131 Electricity By-Law *("Reglamento de la Ley del Servicio Público de Energía Eléctrica")* D.O. May 19, 1994.

engineering, procurement and construction of power plants. This is because under any of the circumstances mentioned the tenderer would risk losing an important sum of money that is guaranteed by the letter of credit or demand guarantee.

Given the volume of documentation that is included in the "technical" and the "economical" bids the opening of the offers is a two stage process. During the first stage only the technical offer is opened and the economical offers remain sealed. Entities involved in the bid process then proceed to evaluate the documentation and information contained in the offers. In order to ensure fairness the evaluation is based solely on the documentation submitted without taking into account any other type of external evidence. A detailed analysis of the technical bids is conducted in accordance with the procedures designated in the bidding guidelines, and the bids that do not fulfil the requirements set forth in the bidding guidelines are declared "Not Technically Viable" . The economic bids of offers declared "Not Technically Viable" are not opened in the second stage of the tender process. The Mexican Constitution[126] and the statutes applicable to the bid process imposes upon the entity conducting the tender process the duty to give reasons for its act. The duty to give reason seeks to restrict unlawful use of discretion and is considered the "hallmark of good administration".[127] If no reasons are given and the decision is appealed, the court may order that the decision be struck down. The obligation to give reasons ensures that the technical bids are evaluated thoroughly and the bidder is notified of the reasons why

[126] Articles 14 and 16 of the Mexican Constitution ("*Constitución Pólitica de los Estados Unidos Mexicanos*"), D.O. February 14, 1917.
[127] Foulkes, David, *Administrative Law, supra* note 64 at 325.

it was felt that his or her bid did not comply with the requirements set forth in the bidding guidelines.

During the second stage the envelopes containing the economic bid of those bidders whose technical bids were determined to be "Technically Viable". The economic bids are also evaluated in order to ensure their compliance with the requirements set forth in the bidding guidelines. The evaluation of the economic bid decides who is going to be designated the winning bidder and the selection is based on the price offered by the participants.

The winner of the award is announced in a public meeting and is also published in the newspaper in accordance with article 1015 (7) of NAFTA. The announcing of the winning bidder constitutes the acceptance. Designating the winner in a public meeting also seeks to avoid problems related to the communication of acceptance.

IV. The Prevention of Corruption and Bribery in the Procurement Process

One of the problems that affect the procurement process is the existence of corruption and bribery. Corruption refers to where a public good or service is sold for personal gain or where a corrupt agent acting to the detriment of the principal

outweighs the cost.[128] Corruption distorts the application of the law, as public rules are applied in a discriminatory manner. Corruption goes hand in hand with the unlawful use of discretion and distorts the results of the procurement process. The eradication of corruption in public tendering procedures is sought in order to enhance participation and uphold the principle of rule of law ensuring that the powers are exercised subject to the limitations set forth in the Constitution and the legislative framework applicable.

Bribery and corruption distort the obligation to act in good faith in public tenders. Bad faith in public tenders distorts the "good value" and "fair treatment" principles that govern public procurement and the credibility of the system is compromised.[129] Where it can be proven that the decision to award a contract to a winning bidder was influenced by bribery and corruption, an interested party may appeal the decision in first instance to the Comptroller's Office (*"Secretaría de la Contraloría y Desarrollo Administrativo"*) and then to the Administrative courts. Any irregularity of this nature may be appealed by an administrative remedy known as *"inconformidad"*[130] and the contract may be declared void for unlawful use of discretion and bad faith.

In Mexico in an attempt to eradicate corruption in the government (which includes the Ministries and public corporations), provisions criminalizing corruption

---

[128] Shihata, Ibrahim F.I., *Fourteenth National Symposium on Economic Crime Corruption: The Enemy Within.* (1996) 15 Dick. J. Int'l L. 451.
[129] Arrowsmith, Sue, *Government Procurement and Contracts, supra* note 63 at 182.

have been included in the legislation which includes the Constitution, the Federal and Local Criminal Codes, the Law of Acquisitions and the Law of Public Works and Services related to the same ("*Ley de Obras Públicas y Servicios Relacionados con las Mismas*"), and the Federal Law of Responsibilities of Civil Servants ("*Ley Federal de Responsabilidad de los Servidores Públicos*"). The criminal sanctions seek to deter corruption by civil servants and reinforce the civil and administrative sanctions in effect. The criminal code establishes sanctions for the following conducts which are regarded as crimes:[131] Undue use of attributions and faculties[132], extortion, intimidation, abusive exercise of functions, traffic of influence, bribery, embezzlement and unjust enrichment.[133] The effect of these provisions is to deter public officials from accepting bribes in administrative acts, including government procurement and constraining their acts to the letter of the law. The provisions in place also seek to prohibit self dealing which is the other face of corruption and unlawful use of discretion.

Bribery and corruption have an adverse impact on the principles of contractual freedom and autonomy of will in a public tender. Often the intention of the briber is ensure securing a contract to the detriment of the public in general and other participants in the tender process.

---

[130] Article 83 of the Law of Public Works and Services Related to the Same (" *Ley de Obras Públicas y Servicios Relacionados con las Mismas* ") D.O. January 4, 2000.
[131] OECD, *Public Sector Corruption*, (Paris, OECD 1999).
[132] Article 214 of the Mexican (Federal) Criminal Code. ("*Código Penal*") D.O. August 14, 1931.
[133] Articles 215, 217, and 218 of the Mexican (Federal) Criminal Code. D.O. August 14, 1931.

On an international level, as of December 17, 1997, Mexico is also a signatory of the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, which requires the parties of the convention to make the bribery of foreign public officers a criminal act. It obligates the parties to implement measures that would counteract any "improper advantage" obtained by virtue of having given an undue pecuniary or other advantage to a foreign public official. The convention contemplates the establishment of criminal penalties for those who bribe public officers and mandates that the bribery of a foreign official is an extraditable offence under the convention.[134] The statutory framework enacted in order to deter corruption derives from the fact that the principle role of administrative law is the protection of legitimate expectation and this can only be achieved by instituting mechanisms that would deter corruption and unlawful use of discretion.

V. The Offer and the Acceptance.

The tenderer as the offeror must submit a bid that is sufficiently definitive and complete, this is because a declaration of will only constitutes an offer if it fulfils these characteristics. In principle the offer should contain all the essential elements of a contract so that a simple acceptance would suffice to create a contract.[135] An offer is a definite promise to be bound provided that certain conditions are met.[136] In public tenders the basic condition to be met is being selected the winner within the time limit

---

[134] Crutchfield George, Barbara., Lacey, Kathleen A., Birmele, Lucy, *The 1998 OECD Convention: An Impetus for Worldwide Changes in Attitudes Toward Corruption in Business Transactions* (2000) 37 Am. Bus. L.J. 485.

[135] Delebecque, Philippe, Pansier, Frédéric-Jêrome, *Droit des Obligations*, *supra* note 18 at 13.

during which the offer is to remain valid and may not be revoked. The bidding guidelines enunciate that the offer cannot be revoked and is open for acceptance by the offeree for a designated period and in order to ensure that this is the case the tenderers are required to file an affidavit assuring that the offers shall remain open for the period designated in the bidding guidelines. This is because in accordance with article 1804 of the Mexican Civil Code the offeror who has undertaken to maintain the validity of an offer for an established period of time is under the obligation to keep it open for that period unless it is rejected in the meanwhile.[137]

Bidders who withdraw their offers notwithstanding the requirement set forth in the bidding guidelines may be included in a list of contractors who have been sanctioned by the government and prohibited from participating in public tenders for at least one year.[138] The ability to sanction the tenderers who resile is an advantage of a procedural nature pertaining to the administration.[139] Private entities do not share the privilege of unilaterally sanctioning a party in default and must sue to secure a sanction. On the other hand public administration may on its own initiative act against the party in default imposing a sanction.[140]

---

[136] Furmston, M.P. **ed.** *Cheshire, Fifoot and Furmston's Law of Contract, supra* note 78 at 30.
[137] Article 1864 of the Mexican Civil Code, June 26, 1932.
[138] Law of Acquisitions and Public Works and Services Related to the same. (" *Ley de Obras Públicas y Servicios Relacionados con las Mismas"*) article 83. D.O. January 4, 2000.
[139] Harris, Donald & Tallon, Denis. **eds.**, *Contract Law Today. Anglo- French Comparisons* (Oxford : Clarendon Press 1989) at 278,279.
[140] Ibid.

The evaluation of the bids and the award itself is a way of ensuring the performance of the obligations under the contract and the lowest price. As is often in the case of government contracts in project finance "the lowest bidder makes bond", this means that tenderer who fulfils the requirements indicated in the bidding guidelines and offers the lowest price is the winner.[141] The developer's ability to perform acquires special relevance, given that the project's success depends to a great extent to the producer's ability to make it a success. In the case of power plants, a license for IPP's and an environment impact permit for both IPP's and BLT's is usually required by the winning bidder in order to develop the project.[142] A license is a mechanism that ensures administrative control and is an important feature while regulating utilities.[143] A license ensures that certain standards have to be met by the license holders in order to maintain the validity of the same and is a way of ensuring compliance with the environmental norms.

VI. "*Clauses Exorbitantes*" and effects of the application of the Administrative Law in the Bidding Process

The so called "*clauses exorbitantes*" which place the government in a stronger bargaining position and confer the right to unilaterally terminate the contract are present during the bidding process. The term "*clauses exorbitantes*" usually applies to contractual provisions but given the fact that the tender documents usually contain the

---

[141] Keyes, Noel W., *Government Contracts in a Nutshell, supra* note 21 at 66.
[142] Buljevich, Esteban., Park, Yoon S., *Project Finance and the International Financial Markets, supra* note 6 at 93, 94.
[143] Foulkes, David, *Administrative Law, supra* note 64 at 108

contractual terms and conditions applicable, the term may also apply to the tender documents.

Article 132 of the Electricity By-Law (*"Reglamento de la Ley del Servicio Público de Energía Electrica"*) acknowledges the difference in the parties' bargaining positions by establishing that if a winning bidder does not enter into the contract with CFE within the period designated in the tender documents, the second most attractive offer may be designated the winner without any need for a re-solicitation. Under this circumstance the bidder may lose the demand guarantee or *stand-by* letter of credit presented with the bid. But if CFE does not enter into the contract within the period designated in the bidding guidelines, CFE is only required to reimburse the winning bidder the non recoverable expenses incurred in the preparation of the tender documents. This means that the consequences for not subscribing the contract on a designated day are very different for both of the parties.

An interpretation of article 132 of the Electricity By-Law (*"Reglamento de la Ley del Servicio Público de Energía Electrica"*) leads us to conclude that contracts that are a result of government procurement are not perfected by the mere consent of the parties (as would be the case of consensual contracts) but require formalities imposed by legislation. It is important to establish exactly when the contract is perfected because upon entering into a contract the parties are not only bound by to what is expressly agreed upon but also to the consequences that derive from their

nature or from good faith, custom or usage of the law.[144] If announcing the winning tenderer was to be considered the acceptance that constitutes the contract, the obligations of the parties would arise there and then.

Due to the above the conclusion is that in contracts that arise as a result of government procurement, the will of the parties has no binding effect.[145] Prohibitive provisions contemplated in the statutory framework lay down conditions for the validity of the legal act. These conditions are akin to the so called "*clauses exorbitantes*", contracting parties cannot deviate from these principles otherwise the act may be deemed invalid for lack of fulfilling the conditions mentioned. [146] The "*clauses exorbitantes*" also enable the government to unilaterally decide not to subscribe the agreement after it has selected the winning bidder.

Given the above, the nature of the award in Mexico seems to be a mere promise to enter into contract which must be followed by the subscription of a formal document which delineates the rights and obligations of the parties. Under this context, if the government decides that it does not want to enter into the contract after the winning bidder has been designated the only option the tenderer may have apart from the reliance damages would be to allege "*perte d' une chance*" or "*perjuicio*" in Spanish and expectation damages[147]. The theory of *"perte d'une chance"* is ideally

---

[144] Article 1796 of the Mexican Civil Code, D.O. June 26, 1932.
[145] Harris, Donald & Tallon, Denis. **eds.**, *Contract Law Today, supra* note 139 at 53.
[146] Ibid at 57.
[147] Ibid at 74.

suited to this stage of the public tender process since in applies to situations which are not truly contractual but are not delictual either.

The theory of "*perte d'une chance*" goes beyond the compensation for the reasonable and documented costs incurred into in the preparation of the tender and seeks to protect the innocent party by giving them what is known as expectation losses which would put the plaintiff in the same position that he or she would have been had the contract been performed.[148] This principle conforms to the fact that the purpose of contract law is "to shelter expectation against inaction".[149] The directness of the damages is an important issue while computing damages. There has to be a causal connection between the act or inaction and the damages that are caused. We are not arguing that the winning tenderer should be compensated for "purely economical loss", but that all direct damages whether they be reliance or expectation interests should be compensated.

The calculation of damages should take into account the "*damnum emergens*" or loss, which includes the expenses incurred into for the preparation of the bid, reasonable and documented expenses. Secondly damages also include the "*lucrum cessans*" or profits of which a party has been deprived given the breach.[150] In this context it would seem like expectation interests fall into the domain of "*lucrum cessans*" which seek to protect a party from a loss of profit that arises from a breach of the obligation to enter into contract. The limitation to the amount of damages seeks

[148] Burrows, A.S., *Remedies for Tort and Breach of Contract* (London: Butterworths 1987) at 17.
[149] Marsh P.D.V., *Comparative Contract Law, France-Germany* (Aldershot: Gower 1994) at 135.

to suppress any compensation for the concept of "*lucrum cessans*" which would include the expectation interest in the contract by limiting the compensation to the "*damnum emergens*".

If the administrative law were not applicable to the bidding process the offeree would be liable for the expectation damages, which refer to the direct and foreseeable damages which are proportional to the loss suffered by the winning bidder and the profit of which he has been deprived.[151] Amount-wise there is a considerable difference between the damages calculated in accordance with the provisions of the civil and the administrative law. In order to ensure fairness, the law should enable the winning bidder the possibility of recovering expectation losses if the contract is not entered into by the parties for reasons not attributable to *force majeure*, or the tenderer's gross negligence or wilful misconduct.

Despite the theory of "*perte d'une chance*" and the reliance damages contemplated in law, the administrative and civil recourses in place would do very little to give the winning bidder effective remedies, if the damages were not paid wilfully by the government. This is because in accordance with article 4 of the Federal Code of Civil Procedures ("*Código Federal de Procedimientos Civiles*") a judgement for damages cannot be enforced against the government by execution or attachment. This leads us to conclude that in the area of contracts that arise as a result of government procurement, the law fails to protect the rights of the private entities

---

[150] Gutiérrez y González, Ernesto, *Derecho de las Obligaciones*, *supra* note 19 at 597.
[151] Mexican Civil Code Articles 2108 and 2109. D.O. June 26, 1932.

against "incursions" from the government tending to shield the interests of the administration.

The obligation to compensate the winning bidder for the non recoverable, reasonable and documented expenses is unfair since it fails to take into account the expectation interest which the plaintiff may have had in the transaction. This is because in the situation indicated in article 132 of the Electricity By-Law (*"Reglamento de la Ley del Servicio Público de Energía Electrica"*) the contract has not been signed for a reason that is not imputable to the winning bidder. The principle of reliance interest enunciates that a party must be compensated against expenses reasonably incurred by relying on the promise of performance.[152] The fact that the legislation acknowledges that the winning bidder shall not be fully compensated if a contract is not entered into is clearly an indication on the inequality of the parties in administrative law. The reason for excluding expectation losses may be in order to limit the recovery to direct damages and to avoid unreasonable demands from the power producer. Whether in contract or in tort the obligation to protect the innocent party against loss is one of the key issues in law. We may argue that contract law may be applicable at this stage of the procedure, despite the lack of a formal written agreement. This conclusion is attributable to the following considerations:

i) The parties have consented to the terms and conditions of the agreement, which are contemplated in the bidding guidelines.

ii) By virtue of the application of the principle of autonomy of will, the parties have freely reached an agreement since there has been an offer and an acceptance.

iii) The prevailing trend is in favour of consensual as opposed to formal contracts. This is of course subject to the will of the legislature but arguably the trend is towards consensual agreements where the written form is not a pre-requisite.

iv) The fact that a party has acted in good faith throughout the bidding process and it would be unfair to curtail their legitimate expectations after the winning bidder has been announced. Additionally, the announcing of the winning bidder in itself can trigger some expenses such as placing orders for primary equipment and planning for construction.

An alternative solution, which would be equitable and would prevent a prolonged dispute between the parties as to the amount of damages, would be to establish that the party who refuses to enter into the agreement would be liable for the amount equivalent to the amount designated for the *standby* letter of credit. This way the damages would be limited but at the same time both parties would be liable for a fixed sum of money. Another way in which this issue may be addressed is to give the winning bidder the possibility of recovering expectation interest if the non

---

[152] Harris, Donald & Tallon, Denis. **eds.**, *Contract Law Today. supra* note 139 at 248

subscription of the agreement is not attributable to the bidder's gross negligence or intentional misconduct.

The nature of the award is akin to a promise to enter into contract. If the procurement process were not regarded as an administrative act, article 2247 of the Civil Code would apply to the juridical act in question. In accordance with the provision mentioned if the promisor refused to sign the contract a judge would be entitled to sign the contract in his or her representation. What this means in essence is that the existence of the "*clauses exorbitant*" makes it possible for the government to unilaterally break a promise to enter into contract. In any juridical act which is subject to the administrative law the government seems to have a substantial amount of leeway to make decisions related to the distribution of obligations and unilateral termination, to the detriment of private participants, and this ultimately has its impact on the binding effect of the act.

VII. Adhesion Contracts and Contracts that arise from Government Procurement.

We have seen that the principle of autonomy of will seems to be relegated to a secondary level in contracts for the project financing of power plants. This leads us to to explore whether any other legal form would be better suited to explain the characteristics of contracts of this nature.

One option may be to indicate that contracts for the engineering procurement and construction of power plants are adhesion contracts. Adhesion contracts, are contracts in which conditions are imposed by one of the parties to the contract and the role of the party is limited to giving his or her adhesion on a take it or leave it basis[153].

In principle adhesion contracts have four basic characteristics:[154]

i) There is an economic inequality between the parties.

ii) The invitation to receive offers in order to enter into contract is made to the public in general and not to an individual.

iii) The contractual provisions are drafted by the party having the economic power in a standardised form that is applicable to all the parties without any negotiation.

iv) The contract is expressed in a highly technical manner which makes it very difficult for a layman to understand its meaning.

Contracts that arise from government procurement tend to fulfil most of the above four characteristics. Although we cannot affirm that there is an economic inequality between the parties. The assets of big transnational companies are often

---

[153] Ghestin, Jacques, *Traité de Droit Civil,* (Paris : L.G.D.J. 1980) at 89.
[154] Marsh, P.V.D., *Comparative Contract Law, supra* note 149 at 297.

comparable to or may even exceed the gross national product of countries. In projects of this nature, the economic inequality between the parties may be contingent upon the need to implement the project and the potential tenderers who can fulfil the requirements to participate in the tender. Another distinction between adhesion contracts and contracts arising from government procurement, is that under usual circumstances the adhesion contract is drafted by the party who is going to assume the obligation to provide the goods and services, the obligation of the adherent is limited to paying.[155] An inverse situation is present in government procurement, where the government is responsible for paying, and the private party is responsible for the engineering, procurement and construction. A third distinction between adhesion contracts and contracts for the project financing of power plants, is that in these contracts the tenderer is always at the liberty to freely indicate the cost of the project and adhesion contracts tend to contain stipulations with respect to the price of the project.

One similarity between adhesion contracts and contracts for the project finance of power plants is the ability of the government to present standardised terms and contracts to the contractor. These terms and conditions are of course subject to a collective negotiation process with all the potential tenderers in the periods designated for questions and clarifications, but nevertheless there is little room for individual negotiation of contractual provisions. The lack of negotiation of the contractual terms and provisions should not lead us to conclude that adhesion contracts are unfair and one sided. One of the objectives sought by the

[155] Harris, Donald. & Tallon, Denis, **eds.**, *Contract Law Today, supra* note 139 at 102

implementation of adhesion contracts is the protection of the consumer's interests. In Mexico templates for adhesion contracts have to be pre-approved by the consumer protection authority ("*Procuraduría Federal del Consumidor*"). The terms and conditions of contracts for the engineering, procurement and construction of power plants are not subject to the approval of any consumer protection authority because the government and the potential tenderers have access to legal advice that would enable them to evaluate the legal and economic consequences of the provisions included in the project documents.

A similarity between adhesion contracts and contracts that are the result of a bidding process is the lack of contractual freedom. Due to this, we may be led to conclude that the contracts in analysis are mere adhesion contracts in the negotiation of which private parties play a relatively passive role. But this is not necessarily true because there the collective negotiation process may be a substitute for individual negotiation. The process seeks to encourage fairness and transparency by letting all the potential tenderers benefit from each other's comments and suggestions to modify the project documents. Besides, government is not always in the stronger bargaining position *vis a vis* the private party, since it may be dependent on a firm with whom it does relatively little business and the firm may be successfully doing most of its business abroad.[156] This situation would be particularly common in contracts for the import of electricity from the United States to Mexico, given the lack of capacity in some states on the US-Mexico border.

VIII. Unilateral Declaration of Intent.

Due the possibility that the contract does enable the parties to negotiate the terms and conditions applicable the doctrine has gone as far as to proclaim that the result is not a contract which requires a convergence of wills but a mere unilateral declaration of intent of one of the parties.[157] In a unilateral declaration of intent, there is no convergence of wills there is only an invitation or an offer to the public at large or a certain segment of the public. In a unilateral declaration of intent the role played by the other party is very limited, as they only entitled to accept the offer in its entirety without modifications or fulfil the condition contemplated in the offer.[158] Moreover, in such declarations whoever meets certain conditions or performs a service stipulated by a party in the offer is entitled to the reward stipulated and the offeror is entitled to fulfil his or her promise. Government procurement contracts, processes do not contemplate a reward for those who fulfil certain conditions. In such transactions there is a formal evaluation of the tender and the subscription of a contract between the parties. In government contracts regardless of the limitations there is still room for contractual negotiations especially collective contractual negotiation as we have seen. The tenderers also have the ability to freely establish the price of the contract on a take it or leave it basis. The price offered by the tenderers is never subject to negotiation and in selecting the bidder the government may only express its assent to the price. These features differentiate contracts for the

---

[156] Arrowsmith, Sue, *Government Procurement and Contracts, supra* note 63 at 75.
[157] Fraga, Gabino, *Derecho Administrativo*, *supra* note 61 at 538.
[158] Gutiérrez y González, Ernesto, *Derecho de las Obligaciones*, *supra* note 19 at 270.

engineering, procurement and construction of power plants from the unilateral declaration of intent.

Moreover, unilateral declarations of intent have a binding effect. If the offer is for a specified period of time the offeror cannot revoke his or her offer until such a period has elapsed.[159] The invitation to tender can be revoked by the government due to policy considerations or other circumstances.[160] This is in distinction to an offer in the general sense, which is considered a unilateral declaration of intent. The characteristics of government contracts may lead us to conclude that despite the apparent lack of contractual freedom the product of government procurement is a contract as opposed to any other juridical act.

In this chapter we have seen the way the government procurement process operates and the principle problems associated to juridical acts that are a result of the procurement process. We have also seen that even though there may seem to be very little leeway for the expression of the private party's will the procurement process does contemplate procedures to receive questions and or clarifications from the private parties which the government may discretionally accept or reject and this may be equivalent to a collective negotiation of the contract. The acceptance and/ or rejection of these proposals may also obey to mechanisms such as political lobbying. Even though on the surface it may seem that the government is in a much stronger position and is dictating the contractual terms and conditions applicable to the

[159] In accordance with article 1864 of the Mexican Civil Code. D.O. June 26, 1932.
[160] Article 132 of the Electricity By-Law D.O. May 19, 1994.

transaction a closer analysis of the situation may reveal that the private parties are exerting a considerable amount of pressure and has a decided impact on the contractual provisions. The investigation of acts that are a result of government procurement has also led us to conclude that the agreement that is entered into among the parties is a contract as opposed to any other juridical act like for instance the unilateral declaration of will.

Chapter 4

Freedom of Contract and Project Financing Power Plants in Mexico

In this chapter we shall analyse whether the principles of freedom of contract and autonomy of the will is a mere fiction in contracts for the engineering, procurement and construction of power plants. The subjective view contends that there can only be a contract when the parties freely manifest their will and reach an agreement. Hence the principle of autonomy of the will is the central theme when proceeding to evaluate contracts from the subjective point of view. Adhesion contracts may be regarded as mere agreements as opposed to contracts in accordance with the subjective theory. This is because in adhesion contracts the will of the parties is relegated to secondary level. In contracts for the project finance of power plants the bidders clearly have the choice of participating in the tenders. Participation is not something that is demanded of them or that they are compelled to do against their will. Moreover, the participants in the tender do have a certain (collective) participation in the negotiation of the contractual terms and conditions. Due to these characteristics the agreements for the project financing of power plants may be considered contracts in accordance with the subjective point of view.

The objective theory of contract submits that contracts are a matter of law and hence there is really no need for contractual freedom. In accordance with the

objective theory, agreements for the project financing of power plants that are the result of a government procurement process are contracts because the law states that they are contracts, there being no need for the parties to enter into any negotiations or express their intention to enter into contract freely. If the objective theory were to be applied to the nature of the agreement for the project financing of power plants, and given the fact that the law states that the nature of these agreements is a contract, there would be little or no need to discuss whether the nature of the transaction is akin to a unilateral declaration of intent or any other agreement.

I. Elements of a Contract for the Project Financing of Power Plants.

In order to do any justice to the discussion on the differences between the civil law of contracts and the administrative law of contracts in project finance transactions, we must begin by establishing what is considered a contract and indicate which conditions are essential to the validity of the contract and which are accessory. The lack of any element that is essential to the validity of the contract contributes to its absolute nullity which renders the contract void *ab initio* without any need for judicial declaration. Deviations from the accessory elements of a contract may be rectified at a later date and are regarded as elements which signify that the contract is affected by relative nullity which may renders the contract voidable but these deficiencies may also be rectified enabling the contract to produce all its effects.[161]

[161] Galindo Garfias, Ignacio, *Derecho Civil*, *supra* note 26 at 250, 251.

The elements that are essential to the validity of the contract in accordance with the Mexican law are:

i) Consent

ii) An object

iii) "*Solemnidad*" or a formality in cases which the legislature expressly imposes that requirement.

Consent is by far the most important element of a contract, this is because there can be no contract without consent. The elements of consent are: an offer and acceptance. In the case of contracts that are the result of the government procurement process, the parties express their consent to enter into an agreement for the engineering, procurement and construction of a power plant by indicating in the offer that they are bound to enter into the contract with the government during a certain period of time if they are selected as the winning bidder. The government on the other hand gives its consent by accepting the terms of the offer by selecting the winning bidder and entering into a contract with the winning bidder. The consent of the parties must not be vitiated by mistake or any other defects of the will.[162] In government contracts of this nature, due to the fact that the tender documents are quite detailed and extensive, it is usually presumed that the consent of the parties was not vitiated by defects. Of course there is always the risk of misrepresentations about experience, financial capacity or any other circumstances which may have an impact on the validity of the contract.

With respect to contractual freedom, the parties consent to the terms and conditions contained in the bidding guidelines by means of the offer and the acceptance. Even under circumstances where the parties subscribe the contractual template included in the bidding guidelines with virtually no room for negotiation, it is acknowledged that there is consent where the offer meets the acceptance. Consent may be express or implied.[163] For government contracts the general rule is that consent is express, there being no room for implied consent, because the offer has to be in writing, and the acceptance is the announcement and publication of the results of the tender.

The second element imposed by Mexican law for the existence of a contract is an object. All contracts have direct and indirect objects. The direct object of the contract is the creation and transmission of rights and obligations.[164] The direct object of BLT contracts for the engineering, procurement and construction of power plants is to create in the government the obligation to begin payments for the lease of the power plant. In IPP contracts the direct object is the realisation of payments for the purchase of capacity and energy. The obligation of the private entity is to construct the plant according to project specifications in both IPP and BLT projects receiving in return periodic payments. The indirect object of the contract[165] is the subject matter that the obligor is required to give, or the act that the obligor must or must not do. The

---

[162] Gutiérrez y González, Ernesto, *Derecho de las Obligaciones, supra* note 19 at 263.
[163] In accordance with article 1803 of the Mexican Civil Code. D.O. June 26, 1932.
[164] Article 1793 of the Mexican Civil Code. D.O. June 26, 1932.
[165] Gutiérrez y González, Ernesto, *Derecho de las Obligaciones, supra* note 19 at 293.

indirect object in projects of this nature is the engineering, procurement and construction of the power plant.

The formality required for the validity of the transaction is that the contract must be in writing. Contracts are generally consensual in nature and are only formal as the result of an express requirement stipulated in legislation. Examples of this phenomenon are contracts for the purchase of land, which must always be in writing and notarized. In most of the other agreements the written form is generally not a requirement. In the case of contracts that arise as a result of government procurement the written form is clearly a requirement as we have seen.

II. The Administrative Law of Contracts vs. The Private Law of Contract in Project Finance.

The Mexican law of administrative contracts is based on the French theory, especially as proposed by Jezè in "*Théorie Générale des Contrats de l'Administration*"[166]. Fraga, the leading authority in Mexico in matters related to administrative law, states that the distinction between administrative and civil contracts is based upon the premise that even though all contracts involve an agreement, not all agreements between the parties are contracts. A contract is

[166] Fraga, Gabino, *Derecho Administrativo*, *supra* note 61 at 538.

essentially bilateral and in order for there to be a contract, two requirements have to be met: consent and an object which can be the subject matter of the contract.[167]

The autonomy of the will is the central issue under the Mexican law of contracts. Autonomy of will means "...a will which determines its rules for itself: the contractual obligation has its source in the will of the parties who alone and freely created the contract and all its effects"[168]. This principle supposes that parties shall freely negotiate the terms and conditions applicable to a particular transaction, this is because in accordance with the theory mankind is free by nature and may only be bound by its own free will. The theory further enunciates that the will of the parties ensure that the contract is fair in nature because people cannot contract against their own interest. The principle of autonomy of will was born as a result of liberal economic theory, which enunciated that mankind was free and equal. The creation of the theory can be attributed to Grotius (1585-1645) but the theory gained widespread acceptance in the 18th Century.[169] This principle encompasses three different aspects:[170]

i) Choice in the person of the co-contractor.

ii) The right to freely establish the contractual terms and conditions in conjunction with the other party.

iii) The principle of consensualism which argues that parties may be bound by their own free will without any need for a written form.

---

[167] Mexican Civil Code. Art. 1794 D.O. June 26, 1932.
[168] Rouhette, Georges, *The Obligatory Force of Contracts in French Law. Contract Law Today. Anglo-French Comparisons* (Oxford : Clarendon Press 1989) at 39.
[169] Ghestin, Jacques. *Traité de Droit Civil* (Paris : LGDJ) at 18,19.

In accordance with the theory of autonomy of will the contract may exceptionally be affected by nullity where there is disequilibria between the rights and obligations of the parties.

This principle of autonomy of will is somewhat limited in government contracts for the project finance of power plants because the terms and conditions are included in the bidding guidelines, and the role played by the individual private participant may seem limited. Given the fact that one of the parties plays a relatively passive role in establishing the contractual terms and conditions it may seem like contractual freedom is a mere fiction in contracts for the project finance of power plants. Generally speaking, the principle of autonomy of will is in decline in the welfare state. The law acknowledges the inequalities existent between the parties. Often the terms and conditions of contracts (especially for the rendering of services) are seldom negotiated by the parties, for example contracts for transportation, travel, parking, dry cleaning, are all subject to pre-established contractual clauses but this does not lead us to conclude that they not contracts because the terms and conditions were not subject to negotiation.

Given the fact that there is relatively little negotiation between the parties, Fraga considers that administrative law of contracts, which involves a public tender is akin to a unilateral declaration of intent as opposed to contract. This is as a result of the characteristic that the government assumes the obligation to compensate whoever

---

[170] Ibid.

fulfils certain conditions within an established time frame. The common law equivalent of what is known in civil law jurisdictions as a unilateral declaration of intent, is a unilateral contract which arises from an act made in response to an offer. [171] In a unilateral declaration of intent there is no contractual negotiation between the parties. But arguably contracts that are a result of a government procurement process cannot be deemed to be a unilateral declaration of intent because of differences between the two different juridical acts that we have discussed in chapter 3 and the existence of pre-established clauses does not necessarily lead us to conclude that a legal act is not a contract.

The characterisation of a contract as administrative would not only be subject to the condition that one of the parties to the contract is the government. All acts concluded by administrative entities are administrative acts but this does not necessarily lead us to conclude that all contracts of this nature are administrative contracts.[172] The public tender conducted for the implementation of the project is considered an administrative act, and in case of any controversy would be subject to judicial review before the administrative courts. A decision rendered in the procurement process can be annulled in case of errors of fact, errors of law or abuse of discretion.[173] The contract that results from government procurement in the case of IPP and BLT projects would be governed by private law (civil and commercial).

---

[171] *The Queen in Right of Ontario v. Ron Engineering and Construction (Eastern) Ltd.* [1981] 1 SCR 111, 119 DLR (3d) 267.

[172] de Laubadère, André, Moderne, Franck., Delvolvé, Pierre. *Traité des Contrats Administratifs.* vol. I. 2nd ed. (Paris : Librairie Générale de Droit et de Jurisprudence 1983) at 126.

The categorisation of a contract as administrative is contingent upon the concurrence of one or more of the following [174] :

i) The law itself designates which contracts are administrative in nature. As we have seen, the sale of capacity and energy by independent power producers is not considered an administrative contract by virtue of law.

ii) The parties by their own free will may determine that the administrative law of contract should apply to a particular transaction. Under this circumstance any dispute that may subsequently arise in relation to the interpretation or performance of the contracts, shall be subject to the jurisdiction of the administrative courts. In this context a public law corporate body must be a party to the contract and the contract should relate to an activity of public service or it should contain clauses that are not used in private contracts.[175]

iii) The nature of the contract plays an important role in determining whether the contract is administrative. Contracts for the construction of public works or rendering of a public service are normally administrative contracts and this translates to the fact that it is clear from the outset that

---

[173] Schuck, Peter H., *Foundations of Administrative Law*, *supra* note 60 at 342-345.
[174] de Laubadère, André, Moderne, Franck., Delvolvé, Pierre. *Traité des Contrats Administratifs, supra* note 172 at 127.
[175] Harris, Donald & Tallon, Denis, eds., *Contract Law Today. supra* note 139 at 279.

the administration shall receive more favourable treatment than the other party.[176]

The characterisation of a contract as administrative has an impact on the contractual freedom of the parties. This is primarily because in administrative contracts there is an inherent legal inequality among the parties. The State in a position of advantage with respect the other party. The government dictates the terms and conditions applicable to a particular transaction.[177] The private entity's rights are limited to adhering to the provisions and guidelines dictated by the government.

Where there is a dispute between the parties as to the interpretation of administrative contracts or the validity of provisions contained in the same the procedure conducted before the administrative courts is largely inquisitorial in nature. The procedure involves the presentation of written pleadings and under normal circumstances there is a total lack of oral submissions by any of the parties. The administrative law is also perceived as being favourable to the government in case of a dispute arising about the performance or interpretation of contract.

The fact that the Electricity Law (*"Ley del Servicio Público de Energía Eléctrica"*) in its article 3 deems that contracts for the purchase of capacity and energy are not administrative contracts, confers a certain amount of leeway for contractual freedom. In practice this freedom is not as apparent; given the surplus of

---

[176] Ibid.
[177] Fraga, Gabino, *Derecho Administrativo*. *supra* note 61 at 550.

qualified contractors and the economic recession (2001-2002), private participants usually have to content themselves to adhering to the terms and conditions established in the project documents. The periods designated for the presentation of questions and comments during the procurement process are no substitute for contractual freedom.

The contract entered into among the parties is classified as a commercial contract of sale (as opposed to a civil contract) in accordance with article 1050 of the Mexican Commercial Code which enunciates that when a transaction has a commercial impact on one party and for the other it is of a civil nature, the transaction shall be governed in accordance with mercantile law.

The Mexican Civil Code is of supplementary application in commercial transactions. That is because article 2 of the Commercial Code states that if there is no provision in that code which is exactly applicable to the transaction, the act shall be governed by the provisions of the Civil Code. The contract for the sale of capacity and energy is perfected the date the parties enter into the contract for the IPP project. This is because the law establishes that a purchase and sale contract is perfected if an agreement has been reached on the subject matter and its price (article 2249 of the Mexican Civil Code).

The distinction between civil and commercial contracts is important regardless of the fact that the rules applicable to civil and commercial contracts are quite similar. This is because commercial contracts are consensual in nature as

opposed to formal, with the exception of contracts result of government procurement, which are subject to their own special rules. This means that generally in such contracts the written form is not a requirement. We have argued that the award should confer certain rights to the private participant and this would be compatible with the principles applicable to commercial contracts but today the written form is an requirement for contracts for the engineering, procurement and construction of power plants.

A major difference between civil and commercial contracts is the role played by "*lesión*" which is the civil law equivalent of unconscionability. This principle seeks to afford protection to parties in a weak bargaining position and who may have unfair contractual terms and conditions thrust upon them. The concept of "*lesión*" in Mexican law seeks to protect a party affected by extreme ignorance, inexperience or hardship which compels him or her to enter into a transaction where the consideration given is disproportionate to the benefit received in return. In accordance with the subjective view, the existence of "*lesión*" would render a contract voidable due to a defect in the consent. On the other hand the objective position is that "*lesión*" is an objective defect of the contract.[178] The concept of "*lesión*" is not applicable to commercial contracts.[179] This is because the law presumes that people who engage in business with a view to profit should know better and have the experience that would enable them to cope with pressure and aggressive sale tactics. Applied to project finance what this means is that neither of the parties can plead the existence of

[178] Gutiérrez y González, Ernesto, *Derecho de las Obligaciones, supra* note 19 at 396.
[179] Ibid at 397.

"*lesión*" or that they were forced to enter into an agreement due to ignorance and hardship in order to render the contract voidable.

III. Contractual Capacity of the Parties.

Contracts involve the concept of consent; it follows that only those who have the capacity to consent can contract.[180] The contracting party must be a person, whether individual or a corporation recognised as such by the law.[181] The capacity of minors and the insane to enter into contract is not relevant in contracts of this nature given the fact that in sophisticated transactions for the project finance of power plants the tenderers have to prove experience in similar projects and financial capacity. Unincorporated associations do not have a legal existence independent from that of its members. If there is a subsequent dispute the person who actually entered into the contract is personally liable. Corporations have independent legal personality and a person with the powers to represent a corporation may bind it. Given the nature of the transactions the contracts are usually entered into by a corporation. This arrangement is also attributable to the advantages that corporations enjoy in terms of risk allocation since the board of directors is not personally responsible for any acts of the corporations and the so called "piercing of the corporate veil" occurs only in exceptional circumstances.

---

[180] Fridman, G.H.L., *The Law of Contracts, supra* note 17 at 138.
[181] Furmston, P.M. **ed.** Cheshire, *Fifoot & Furmston's Law of Contract, supra* note 78 at 456.

In entering into contracts of this nature the government acts through its agent who is responsible for the negotiation and implementation of any competitive procedures to reach an agreement. As is usual in government contracts the ordinary rules of agency tend to apply to the transactions. The agent is not himself bound but the government is bound if the agent acts within its jurisdiction.[182] If the agent is not duly authorised to enter into the contract on either of the parties behalf, the contract is deemed to be null and void, this is unless the non-authorising party subsequently ratifies it prior to the retraction of the offer or acceptance by the other party.

IV. Project Finance and the Classification of Contracts.

Given the fact that at civil law the nominate contract is the norm, the first task the lawyer is faced with is to attempt to classify a particular transaction and establish which category of contract it falls into. Project finance contracts are bilateral, onerous and formal contracts. Although at first glance it may seem like the contracts for the project financing of power plants are innominate contracts, an analysis of the contractual provisions tend to suggest that they share some of the characteristics of the contracts for works.[183] This is because the Project Developer is under the obligation to execute the project in accordance with the contractual terms and the specifications contained in the tender documents. The risk allocation scheme also tends to accept that the contract is akin to a contract for public works, because the project developer is presumed to be reasonably competent in the field of work in

[182] Turpin, Colin, *Government Procurement and Contracts*, *supra* note 62 at 94.

question and hence required to assume the commercial risks. The Project Developer is also presumed to be the "master of his art" and is assumed to be technically competent while selecting his suppliers and contractors and detecting unsuitable methods.[184] The reception of the plant after the commercial operation date is classified as a "single and unique judicial act"[185] which requires the delivery of a provisional acceptance certificate by the government.

In an IPP model, during construction the contract allocates rights and obligations in a manner similar to that prevailing in the contract of works. After the commercial operation of the plant has been attained, the contractual relationship between the parties with respect to the purchase of capacity and energy is something akin to a contract for the sale of a commodity. The producer is under the obligation to deliver electricity at an interconnection point and the purchaser is under the obligation to accept what is being offered if it conforms to the contract specifications.

The contract for the engineering, procurement and construction of power plants is a principal contract. Agreements for the financing of the transaction, contracts with subcontractors and other similar agreements are accessory to the principal agreement.

---

[183] Bailón Valdovinos, Rosalío, *Práctica Forense Contractual en Material Civil* (Mexico City: Angel Editor) 2000 at J-297.
[184] Marsh, P.D.V., *Comparative Contract Law*, *supra* note 149 at 184.
[185] Ibid at 185.

V. Contractual Freedom and Project Finance.

In "The Death of Contract" Grant Gilmore argues that classical contract theory bears a close resemblance to the "liberal" model and "laissez-faire economic theory" under which parties enjoy a "complete mobility and freedom of decision".[186] This doctrine would be consistent with the principle of autonomy of will under which the parties enjoy a broad freedom to act exactly how they please. This premise is attractive enough in theory, but it does not necessarily follow that its application is generalised in practice.

In practice contractual freedom may seem to be a mere utopia because under usual circumstances the party in the stronger bargaining position dictates contractual terms and conditions to the other party. This circumstance is not only true of contracts for the construction of public works but any agreement in general. In leases the landlord usually imposes the terms and conditions to the tenant. In contracts for the sale of goods, depending on the supply and demand, the seller or the buyer may impose the terms and conditions. In franchising agreements the franchisor usually has the upper hand and banks certainly dictate the terms and conditions applicable to loan agreements. Why should the situation be any different in contracts for the engineering, procurement and construction of power plants ? In contracts of this nature depending on the number of qualified contractors for a certain project the private party or the government may end up dictating the terms and conditions. In highly competitive projects the government may play a major role in establishing the

contractual terms and conditions given the fact that there is no shortage of qualified contractors. In highly specialised projects given the shortage of contractors the private party plays a greater role. The prevailing situation has nothing to do with the basic principles of contract law that seek to ensure fairness. They obey more to economic factors, which have a decided impact on the bargaining power of the parties.

The hurdles in place in contracts for the project financing of power plants are not always unreasonable and could be based on public policy considerations that might be justifiable given the importance of projects of this nature. Moreover, the indiscriminate removal of all barriers to contractual freedom in contracts of this nature may have negative repercussions in terms of the timing and quality of the projects and the price of the service. Given this scenario the role of the government is to adhere to the principles of fairness and natural justice in the implementation of these projects taking into account the private party's needs and concerns. On the other hand the duty of the private parties is to be reasonable in their requests and express their concerns during the tender process as opposed to after the winning bidder has been selected. This we feel, would be the best way to conciliate the interests of the parties in transactions for the project finance of power plants.

---

[186] Gilmore, Grant, *Death of Contract* (Columbus : Ohio State University Press 1974) at 103.

Conclusions

Given the legal framework in effect in Mexico, contracts for the project financing of power plants are contracts that arise as a result of government procurement. All acts concluded by governmental entities are administrative acts but it does not follow that contracts that arise from this process are necessarily administrative contracts. This distinction is of special relevance in a civil law jurisdiction such as Mexico because different rules are applicable to administrative and civil contracts. The fact that contracts for the project finance of power plants are not subject to the public law also means that conditions such as the infamous "*clauses exorbitantes*" which confer rights of unilateral termination of the contract to the government are not present and there is room to protect the private party's legitimate expectations. The non-existence of "*clauses exorbitantes*" is true of the contractual phase. Nevertheless, before the formal agreement has been subscribed by the parties, the government may resort to not signing the agreement after announcing the award. This could be achieved without any need to give reason and by paying damages that do not reflect the actual losses suffered by the private party. The existence of provisions limiting the government's liability is a reflection of the inequality between the parties in contracts of this nature.

The fact that the contracts are not governed by the administrative law of contracts confers the parties a certain amount of leeway for negotiation of contractual terms and provisions. This is something that does not happen in contracts for the

construction of public works, which are subject to the administrative law of contracts. In contracts governed by the administrative law of contracts the contractual freedom of the parties is practically non-existent. In these transactions, the role of the offeror (the private party who presents the bid) is limited to stipulating the price that shall be applicable to the contract. Most of the terms and conditions that shall be applicable to the transaction are contained in the bidding guidelines and the Law of Public Works and Services Related to the Same "*Ley de Obras Públicas y Servicios Relacionados con las Mismas*". Regardless of whether the contracts are governed by private or administrative law the government has the ability to unilaterally impose terms and conditions on the private participant. The role that the parties play in the negotiation of the contractual terms and conditions is also contingent upon the urgency of the projects and availability of suitable contractors. In specialised projects where the potential tenderers are limited, the government, in an effort to find a qualified contractor, may resort to accepting conditions imposed by the other party. The situation is very different in projects which are highly competitive and where the government has the ability to practically dictate the terms and conditions applicable. This reality is a reflection of the fact that regardless of the state of the law, the voice of the party in the stronger bargaining position is what prevails. The principle of freedom of contract is premised on an scenario where the ground has been levelled by the parties and they essentially have the same bargaining power. This is something that rarely happens in practice and hence the principle of freedom of contract is utopia.

Autonomy of will is a primary concern in contracts but at the same time there is the need to ensure that some of the parties who participate in the bidding process are not in a better bargaining position to the detriment of the others. This is given that some of the tenderers have access to better legal advice or are more aggressive negotiators and lobbyists to their advantage. At the same time there measures must be taken to ensure that the rights of those who lack these characteristics are not affected to their detriment. A way in which this may be achieved is to interpret contracts in good faith in order to establish the true intention of the parties and not only interpretation restricted to the wording of the contract. This solution is not without its risks and may distort the purpose of contract law, which is to ensure continuity, cohesion and predictability. This purpose may not be attained by the application of the good faith doctrine, which seeks to discover and to give way to the parties intention.[187]

The primary conclusion is that freedom of contract is a concept that is an ideal but it is not realistic to expect that parties will play equivalent roles while negotiating contracts. This is something that rarely happens in practice in private and government contracts. Contractual freedom and the principle of autonomy of will are mere fictions. Consent is composed of the offer and the acceptance. In projects of this nature the offer is limited to establishing the price and compliance with project specifications. The acceptance is restricted to agreeing to the terms and conditions of the offer. Given this sequence of events, there is little room for contractual freedom.

---

[187] Zimmermann, Reinhard, Whittaker, Simon **eds.** *Good Faith in European Contract Law* .(Cambridge: Cambridge University Press 2000) at 13.

BIBLIOGRAPHY

Cases

Irvine v. Canada (Restrictive Trade Practices Commission) [1987] 1 SCR 181 (Can.).

Kawneer Co. v. Bank of Canada (1982), 40 O.R. (2d) 275 at 283.

The Queen in Right of Ontario v. Ron Engineering and Construction (Eastern) Ltd. [1981] 1 SCR 111, 119 DLR (3d) 267.

R. v. Sussex Justices, ex p McCarthy [1924] 1 KB 256 at 259.

Rooke's Case (1598) 5 Co. Rep. 99b.

Legislation

The Mexican Constitution (*"Constitución Política de los Estados Unidos Mexicanos"*) D.O. February 5, 1917.

The Mexican Civil Code (*"Código Civil para el Distrito Federal en Materia Común y para toda la República en Materia Federal"*) D.O. June 26, 1932.

Criminal Code. ("*Código Penal*") D.O. August 14, 1931.

Administration Law (*"Ley Órganica de la Administración Pública Federal"*) D.O. December 29, 1976.

Federal Law of Responsibilities of Civil Servants *("Ley Federal de Responsabilidades de los Servidores Públicos"*) D.O. December 31, 1982

Law of Public Works and Services Related to the *Same ("Ley de Obras Públicas y Servicios Relacionados con las Mismas"*) D.O. January 4,2000.

Electricity Law (*"Ley del Servicio Publico de Energia Electrica"*) D.O. December 22, 1975.

Electricity By-Law (*"Reglamento de la Ley del Servicio Público de Energía Eléctrica"*)
D.O. May 31, 1993.

Secondary Materials.

Ahmed, Priscilla. & Xinghai, Fang, *Project Finance in Developing Countries* (Washington, D.C.: International Finance Corporation 1997).

Arrowsmith, Sue, *Government Procurement and Judicial Review*. (Toronto: Carswell 1988).

Bailón Valdovinos, Rosalío, *Práctica Forense Contractual en Materia Civil* (Mexico City: Angel Editor 2000).

Barry, Nicholas. *The French Law of Contract. Contract Law Today. Anglo- French Comparisons,* (Oxford : Oxford University Press 1989).

Benoit, Philippe, *Project Finance and the World Bank*, World Bank Technical Paper No. 312 (Washington D.C.: The World Bank 1997).

Blaine, Michael James, *Co-operation in International Business. The Use of Limited Equity Arrangements* (Aldershot: Avebury 1994).

Buljevich, Esteban C. & Park, S. Yoon. *Project Financing and the International Financial Markets* (Boston: Kluwer Academic Publishers 1999).

Burgoa, Ernesto, *El Juicio de Amparo*, 38th ed. (Mexico City: Editorial Porrúa 2001).

De Laubadère, André, Moderne, Frank & Delvolvé, Pierre, *Traité des Contrats Administratifs*. vol.1 (Paris: Librarie Générale de Droit et de Jurisprudence 1983).

Delebecque, Philippe, Pansier, Fédéric-Jérôme, Pansier, Droit des Obligations (Responsabilité Civile – Contrat) 2nd ed. (Paris: Litec 1998).

Focardi, Sergio. & Jonas, Caroline, *Risk Management: Framework, Methods and Practice* (New Hope PA.: Frank J. Fabozzi Associates 1998).

Foulkes, David. *Administrative Law*. 8th ed. (London : Butterworths 1995).

Fridman, G.H.L., *The Law of Contract in Canada*, 3rd ed. (Toronto: Carswell 1994).

Furmstom, M.P., **ed.**, *Law of Contract. Cheshire, Fifoot and Furmston's Law of Contract*. 13th ed., (London: Butterworths 1996).

Hansen, John., Nanivska, Vira., *Economic Growth with Equity, Ukranian Perspectives*, World Bank Discussion Paper No. 407 (Washington D.C. : The International Bank for Reconstruction and Development, The World Bank 1999).

Galindo Garfias, Ignacio, *Derecho Administrativo*, 20th ed. (Mexico City: Editorial Porrúa 2000).

Gellhorn, Ernest., Levin, Ronald M., *Administrative Law and Process in a Nutshell,* 4th ed.(St. Paul, Minn., West Publishing Co.).

Gilmore, Grant. *The Death of Contract* (Columbus: Ohio State University Press 1974).

Grusn, Michael & Hutter, Stephan et al. *Legal Opinions in International Transactions,* 3rd. Ed. (London: Kluwer Law International 1997).

Harding, Arthur L., **ed.**, *The Rule of Law* (Dallas: The Southern Methodist University Press 1961).

Harris, Donald & Tallon, Denis, **eds.**, *Contract Law Today* (Oxford: Clarendon Press 1989).

Herman, Barry, **ed.**, *Global Financial Turmoil and Reform a United Nations Perspective,* (Tokyo, United Nations University Press 1999).

Horn, Norbert **ed.**, *The Law of International Trade Finance.* (Boston, Kluwer Academic Publishers 1989).

Horowitz, Shale & Heo, Uk, **eds.**, *The Political Economics of International Financial Crisis* (London: Rowman and Littlefield Publishers Inc. 2001).

Kessler, Timothy P., *Global Capital and National Politics, Reforming Mexico's Financial System* (Westport CT: Praeger Publishers 1999).

Keyes, Noel W., *Government Contracts in a Nutshell,* (St. Paul, Minn. : West Publishing Co. 1989).

Kleim, Ralph L & Ludin, Irwin S., *Reducing Project Risk* (Aldershot: Gower Publishing Ltd. 1997).

Lang, Larry H.P., *Project Finance in Asia* (Netherlands: Elsevier 1998).

Marsh, P.D.V., *Comparative Contract Law England, France-Germany* (Aldershot: Gower 1994).

MacCallum, Robert Kenneth, *Sovereign Debt Restructuring. The Rights and Duties of Commercial Banks.*(Washington D.C.: The World Bank 1997).

Mitsuhiro, Fukao. *Financial Integration of Corporate Governance and the Performance of Multinational Companies* (Washington D.C.: The Brookings Institute 1995).

Milner, Chris, *Export Promotion Strategies. Theory and Evidence from Developing Countries* (New York: New York University Press 1990).

Monahan, Patrick J. *Constitutional Law* (Concord : Irwin Law 1997).

Mullan, David J., *Administrative Law*, (Toronto: Irwin Law 2001).

Nieman, Auerbach Nancy, *States Banks and Markets Mexico's Path to Financial Liberation in Comparative Perspective* (Oxford: Westview Press USA 2001).

Nevitt, Peter K. *Project Financing,* 4th ed. (Bath: Euromoney Publications 1983).

Romano, Roberta. **ed.**, *Foundations of Corporate Law.* (New York: Oxford University Press 1993).

Rojas Suárez, Liliana, **ed.**, *Safe and Sound Financial Systems What Works for Latin America* (New York: Interamerican Development Bank 1999).

Sánchez Bringas, Enrique, Derecho Constitucional, 6th ed. (Mexico City: Editorial Porrúa 2001).

Shapiro, Ian, **ed.**, *The Rule of Law*, Nomos XXXVI (New York: New York University Press 1992).

Schuck, Peter H., *Foundations of Administrative Law,* (New York: Oxford University Press 1994).

Sornarajah, M., *The International Law of Foreign Investment* (Cambridge: Cambridge University Press 1994).

Swan, John & Reiter, Barry J., *Contracts, Cases Notes and Materials*, 4th ed., (Toronto: Emond Montgomery Publications Ltd. 1991).

Turpin, Colin, *Government Procurement and Contracts,* (London. Longman 1989).

Vincent, Andrew, *Theories of the State* (Oxford : Basil Blackwell Ltd. 1989).

Wade, William & Forsyth, Christopher, *Administrative Law*, 8th ed. (Oxford: Oxford University Press 2000).

Whincup, Michael H., *Contract Law and Practice, The English System and Continental Comparisons*, 3rd ed. (Hague: Klewer Law International 1996).

Ziegel, Jacob S., Geva, Benjamin and Cuming, R.C.C., *Secured Transactions in Personal Property, Suretyships and Insolvency* vol. III., 3rd ed. (Toronto: Emond Montgomery 1995).

Zimmermann, Reinhard, Whittaker, Simon, **eds.** *Good Faith in European Contract Law*, (Cambridge: Cambridge University Press 2000).
OECD, *Foreign Direct Investment, OECD Countries and Dynamic Economies of Asia and Latin America* (Paris : OECD Publications 1995).

Law Journals.

Bjerre, Carl S., *International Project Finance Selected Issues under Revised Article 9*, American Bankruptcy Journal, (1999) National Conference of Bankruptcy.

Crutchfield George, Barbara., Lacey, Kathleen A., Birmele, Lucy, *The 1998 OECD Convention : An Impetus for Worldwide Changes in Attitudes Toward Corruption in Business Transactions*(2000) 37 Am. Bus. L.J. 485.

Dugue, Christophe, *"Dispute Resolutions in International Project Finance Transactions"* (2001) 24 Fordham Int'l Law Journal 1371.

Shihata, Ibrahim F.I., *Fourteenth National Symposium on Economic Crime Corruption: The Enemy Within.* (1996) 15 Dick. J. Int'l L. 451.

Stelwagan, William., *"Financing Private Energy Projects in the Third World"* (1996) 37. Catholic Law 45.

Mauel, John G., *"Common Contractual Risk Allocations in International Power Projects"* (1996) 1996 Colum. Bus. L. Rev. 37.

Wallace, Don Jr., *"Host Country Legislation a Necessary Condition"*, (2001) 24 Fordham Int'l LJ 1396.

Websites

< http://www.energia.gob.mx/wb/distribuidor.jsp?seccion=74> last accessed October 5, 2002.

<http://www.cfe.gob.mx/www2/queescfe/notaqueescfe.asp?seccion=queescfe&seccion_id=2271&seccion_nombre=Generaci%F3n> last accessed October 5,2002.

<http://www.energia.gob.mx/wb/distribuidor.jsp?seccion=142> last accessed October 5, 2002.>

<http://www.energia.gob.mx> last accessed October 5, 2002.

<http://cfe.gob.mx/www2/noticia_...id=&seccion_id=1359&publicacion=50> last accessed October 5,2002.

<www.cfe.gob.mx/recursos/publicacion_id46/informe.99CFE.zip> last accessed October 5, 2002.

< http://www.cre.gob.mx/publica/informe99/informe_1999.pdf> last accessed October 5, 2002.

<secofi.gob.mx> last accessed October 5, 2002.

<http://cfe.gob.mx/www2/noticia_...id=&seccion_id=1359&publicacion=50> last accessed 25 September 2001.

<http://200.23.166.206 :1030/publicaciones/secele.pdf> last accessed October 1, 2002.