Notes on the improvement of the earnings situation of the Mexican Light and Power Company, Limited.

The following notes on the improvement of the earnings situation of The Mexican Light and Power Company, Ltd., a Canadian company with its head office in Toronto and with all of its operations in the Federal District of Mexico and the five surrounding states, can naturally give only an outline of some of the major steps involved in this improvement of the position of the company. The negotiations with the Government of Mexico and the regulatory authorities covered a period of years, and the studies made by the Government and the regulatory bodies and by the Company and the successive steps taken on the basis of these studies, have been gradual and are still in progress.

What is today the Mexican Light and Power Company, Ltd., began its operations in 1903 with the establishment of the hydroelectric plant of Mecca some 170 kilometers from Mexico City with an installed capacity of 5617 Kw. Today the Company has 19 plants with a total installed capacity of 57,097 Kw. All of the installed capacity of the Company has been built by it, and whatever small plants have been acquired by the company since 1903 in the area served by it, which is the most important industrial area of Mexico, have been abandoned as insufficient. The installed capacity of the Company therefore all represents investment by the Company in new plant and distribution facilities.

In 1946 the rapidly increasing industrial and general development of the economy of Mexico and principally of the central area which the Mexican Light and Power Company serves, made necessary a study of the needs for the next ten years of the additional generating and distribution facilities needed in the central area. Up until the late 1930s the needs of the central area for electricity have been served entirely by the Mexican Light and Power Co. In 1937, the Government established the Federal Power Commission (Comisión Federal de Electricidad) to build generating plants and distribution lines in areas then not served by the existing private companies. Shortly after the formation of the Federal Power Commission, the Mexican Light and Power Company found itself under the necessity of ceding back to the Government a concession which it had for the important hydroelectric system which is now known as the Miguel Aleman system. The company was unable, because of its financial situation and the inadequate treatment it had received in the way of rates and facilities to exploit this concession, and therefore had to cede it back to the Government, as it was obvious that this important hydroelectric possibility had to be exploited to meet the needs of the central area which the company could not supply, because of its financial position. The Government gave this concession to the Federal Power Commission which, with government funds, a 10% tax on consumption and through foreign loans (Export-Import Bank) secured the funds for what is now the
Miguel Alemán System. The important central area of Mexico therefore, which had previously been served only by the Mexican Light and Power Co., Ltd., is now served by the Mexican Light and Power Co. and by the power which it buys from the Federal Power Commission produced in the Miguel Alemán System, which today has an installed capacity of **Kw.** The study of the electricity needs of the central area for the next ten years began in 1946 by the Mexican Light and Power Company and by the Federal Power Commission, was to determine the needs for new power and distribution facilities in the central area during the ten-year period following. As a result of this combined study the projected needs were determined and the estimated cost. It was found that this program for the central area was a very important one so far as cost was concerned, and indispensable if the power needs were to be met for the constantly developing industrial, commercial and domestic load.

For the Mexican Light and Power Company the estimated cost of the work it would have to do during that period, was approximately 52 million dollars in foreign currencies and in Mexican pesos. In view of the credit situation of the company, due to inadequate treatment by the Government over a considerable period of years, the only possibility for the company to proceed with such a program was on the basis that it would be able to secure a foreign loan for 26 million dollars, which represented the cost of the foreign equipment to be purchased which was not produced in Mexico, of this approximately 52 million dollars program. The Federal Power Commission for its program needed some 24 million dollars, which represented the cost of the imported equipment for its program.

The Government, realizing the imperative necessity of this program of the Mexican Light and Power Company and the Federal Power Commission, speaking now only of the central area, began to realize that, unless the private electricity companies were given more adequate treatment through the implementing of its own electricity law published in the Diario Oficial of February 11, 1939 under the administration of then President Lázaro Cárdenas, it would be quite impossible for the private companies of for the government, to secure the foreign borrowing needed. The Mexican Light and Power Company, for example, had not paid any dividend on its common stock since 1913, and none on its preferred stock since 1931, and was some 11 million dollars in arrears on its income debenture stock. All it had been able to do in all these years was to pay interest on its bonded indebtedness which, relative to the value of the properties, was small. The prevailing rate of return in Mexico on government bonds was not less than 7% net, and bonds of first-class commercial and industrial establishments were paying more, and up to 10%. This was too high a price to pay for long-term money for the private electricity industry, as its reflection in rates to the public would have been too great. The return on the common
and preferred stock of industrial and commercial companies of first standing was invariably higher than 10%. The Government, with the many needs for the development programs and with the increasing need for money for private investment in industry, realized that foreign loans were indispensable for this electricity program. The electricity law of Mexico of February 11, 1919, in Article 142 states that the annual return which will be fixed for the private electricity industry will take into account the return of other public services, and in general the return on other similar investments from the point of view of risk, quantity and term. It says that in no case shall a percentage return be fixed on the capital which is lower than that established for bonds and obligations of the Government. It further states that the return fixed by the regulatory body of the Government for these private companies shall be sufficient always to cover the interest on its obligations, bonds and shares issued by the company, and also a corresponding profit on the capital of the company invested in the business. This article of the law had not been implemented and the return of the electricity companies was approximately about half of the current tax-free return of 7% on government bonds.

The Mexican Light and Power Company on the basis of the assurances of the Government that it was prepared to study the real needs of the company and meet them, decided to go ahead with this very considerable program of generating and distribution works. It made an application to the World Bank towards the end of 1947 or the beginning of 1948 for a long-term loan of 26 million dollars to cover the foreign currency costs of the materials which had to be secured abroad for the program. The Federal Power Commission about the same time made an application for a loan of 24 million dollars to cover additions to the Miguel Alemán System in the central area and for works in other parts of the country.

The World Bank after studying in great detail through its own technical and financial staff and through studies which it had made by outside experts in the matter, arrived at the conclusion that the coordinated programs of the Mexican Light and Power Company and of the Federal Power Commission for the central area were well made and represented a minimum as far as the needs of the central area for increased power to 1955 were concerned. The studies made by the Bank were exhaustive not only of the need for increased power but of the financial position of the Mexican Light and Power Company and of the Federal Power Commission. The Bank arrived at the conclusion that a loan of 26 million dollars to the Mexican Light and Power Company and of 24 million dollars to the Federal Power Commission would be a constructive measure. In conversations with the company and with the Comisión Federal de Electricidad and with the higher authorities of the
Mexican Government the Bank made it clear that it was interested in maintenance of the private power companies in the production of electricity and distribution of electricity in Mexico, and that it realized also the part which the Federal Power Commissioner was playing particularly in areas where private companies were not established. It did not wish to lend only to the private companies or to the Federal Power Commission as a government agency alone. It wished to lend to both. A primary consideration of the World Bank was that the Mexican Light and Power Company should be in a sound financial position, so that it could earn a reasonable return on its investment - which involved earnings sufficient as provided for in the electricity law of 1939, to cover the interest on existing and new bonds of the company and a reasonable return on its capital investment. So far as the Federal Power Commission was concerned, the Bank wished to be assured that the Commission would have available the peso funds needed to complement the loan solicited from the World Bank for the foreign equipment costs. The Bank indicated that it did not wish the loans solicited to be a "rescue" operation but that the loans to the Mexican Light and Power Company and to Federal Power Commission should serve as the basis of meeting the existing situation and laying the basis on which both the Power Commission and the Company could, as the need for further generating and distribution facilities developed, be able to secure the necessary funds for such further development. The Mexican Government was in accord with these ideas and agreed with the Bank that it would put the Mexican Light and Power Company in a sound financial position through the rate of return given to it.

The loans were granted, the programs started, and the program for which these loans of 26 million dollars to the Mexican Light and Power Company and of 24 million dollars to the Federal Power Commission were granted, have been completed.

The Government began through the Commission for Electricity and Gas Tariffs - which is the regulatory organ of the Mexican Government for the fixing of tariffs for electricity and gas and which in accord with the law as amended, is now an autonomous body - to make exhaustive and thorough studies of the needs of the Mexican Light and Power Company through the series of tariff increases which have been granted by the Commission, the last being made effective on October 1st, 1954. The return of the Company has been gradually increased until its present gross return is approximately 13.97% and the net return approximately 9% after paying taxes. This has enabled the Company to resume dividend payments on its common stock and preferred stock under the reorganized financial structure of the Company - the first dividend having been paid towards the end of 1953 and the first common stock dividend towards the end of 1954.

The negotiations which led to the gradual improvement in the financial situation of the Company through the granting of new tariffs, were long and laborious.
The program of construction of new generating and distribution facilities and the improvement of existing distribution facilities and service to the customers involved an expenditure by the Mexican Light and Power Company during the years 1946 to 1954 inclusive, of approximately 75 million dollars in foreign currencies and pesos—this amount including the program for which the 26 million dollars was borrowed from the World Bank. The result of the initiative of the Mexican Light and Power Co. in going ahead with this very considerable program, and of the work done by the Federal Power Commission in the central area on the Miguel Alemán System, and of the more helpful and understanding attitude shown by the Mexican Government towards the private electricity companies, was first, that the rapidly and constantly developing needs for additional power for all purposes in the central area could be and are being met; and second, that industrial, commercial, and financial circles in Mexico were able to go ahead with near- and long-range planning for the development of industry, having the certainty that the power would now be available as and when new industries were ready for connection. In summary, the constructive action of the Mexican Light and Power Company and of the Government made it possible for the movement towards industrial development in the central area to go forward with all assurance, and this was one of the major factors in the very considerable increase in the economic power of the central area.

As the programs already set forth above were approaching completion, the need for a further study of the electricity needs of the central area for the next ten years and for the rest of Mexico became obvious, and in early 1954 the Mexican Government undertook through a commission which it appointed to make a study of the electricity situation in all of Mexico. This commission composed of three men, immediately began its work in early 1954 and expects to conclude it by the middle of 1955. The purpose of this study is threefold: first, to determine what the increase in generating and distributing facilities will have to be during the next ten years, both in the central area and in other zones of Mexico; second, to determine what the cost of these new facilities will be; and third, to determine how these works can be financed. It will be apparent that this new study about to be completed of the whole country is a continuation of the constructive measure undertaken by the Mexican Light and Power Company and the Federal Power Commission in 1946 in making the study on the central area already referred to. The World Bank has shown a continuing interest in the electricity situation in Mexico as, because of situations peculiar to the country and its natural resources electricity has been, is, and will remain for years to come the principal source of energy for industrial and agricultural as well as for domestic and commercial use. If the rhythm of industrial and agricultural development which has been in progress now for almost 2 decades in the country, is to continue, it is now generally recognized in governmental as well as in business circles and among the public, that there has to be this long-range planning of power facilities and realistic provision for the financing thereof.
The Mexican Light and Power Company - on the basis of the estimates it has made in the central area which it serves and in which it has this long experience since 1903, has come to the preliminary conclusion that, if it does all of the additional generation and distributing facilities in the central area of Mexico, and which, as already stated, is the most important in the country, the total expenditure will be between 140 and 150 million dollars in foreign currencies and in pesos. This involves a tremendous financing effort by the company.

Up to now the entire investment of Mexlight has been supplied by foreign investors in the United States, Canada and England and other parts of Europe, and by the loan of 26 million dollars from the World Bank. During the last few years the Mexican Government through Nacional Financiera, S.A., has made very considerable loans in pesos to the Mexican Light and Power Company on a long-term basis (amortization in 24 years) and at an interest of 7%. The situation which confronts Mexlight and the other private electricity companies in Mexico is very different from that which presented itself when the Mexican Light and Power Company and the Power Commission made their applications in early 1946 to the World Bank for the 26 million and the 24 million dollar loan respectively. Through the improved treatment of the private companies by the regulatory bodies in the Government and the better understanding of the importance of electricity as the basic factor in the development of the economy of the country, the Mexican Light and Power Company is now for the first time in a position to endeavor to raise money for program needs through equity financing abroad and, it is hoped, in Mexico, and also its creditworthiness before lending agencies is strengthened through its better earning capacity. It has been the opinion of the Mexican Light and Power Company for years and it is now the expressed opinion of the appropriate authorities of the Government, that it is highly desirable in the interest of the Company and of the Government and of the consuming public, that the private companies be in a position to raise equity capital in Mexico itself, and to get a considerable body of Mexican investors interested in the private companies. This will be the surest way of the Company being able to get the return on its capital which it needs and of the Government to aid it in getting this return. Appropriate steps are now under active consideration by the Mexican Light and Power Company for the placing of new equity issues in dollars and in pesos abroad and in Mexico to raise a substantial part of the cost of this new program of additional works needed during the next ten years which, as already said, will run into between 140 and 150 million dollars. It is recognized all around that, while some of the cost of this program will have to come through long-term borrowing, an appropriate percentage must come from equity financing and from reinvestment of earnings of the Company after paying a reasonable return on its capital to the holders of its shares.
by the Mexican Government are known, it is obvious that new legislation will be necessary in order to implement the conclusions of the study, and it is hoped that the appropriate legislation may be ready for presentation to the Congress of Mexico during the session beginning September 1st, 1955.

The electricity law of Mexico of 1919 has many good features, but with the progress of time it has become obvious that certain changes therein are not only desirable but necessary. The action by the Congress in implementing through appropriate legislation the findings of this commission studying the electricity situation throughout the country and the means of solving it, will be the determining factor as to whether electric power will be available in the central area and in the rest of the country during the next decade.

It would be overburdening and complicating any statement on the subject of this memorandum to set forth even in resume the details of the problem of assuring the private electricity industry a reasonable return on its investment and one which enables it to do the additional equity financing and long-term borrowing which are needed for new works. It is not only the question of the rate of return which is fundamental, but the assuring of adequate and prompt adjustments in tariffs to meet increased costs of operation such as wage increases, cost of fuel, increased taxes or increased cost of materials which cannot be foreseen when rates are fixed by the government regulatory bodies and which must be subject to prompt adjustment as such unforeseen increases in operating costs occur. It is basic for the life of the private electricity industry that such adjustments be made properly. Changes in the electricity law should cover not only the foregoing, but also provisions which will generally assure a sound financial position of the private companies.

The three principal private companies operating in Mexico are: The Mexican Light and Power Company, Ltd.; The American and Foreign Power Co., through its subsidiaries in Mexico; and the Canadian Montreal Company, operating in Monterrey. Of these, the Mexican Light and Power Company operates only in the central area of Mexico already described, and has no operations outside of Mexico. The American and Foreign Power Company has subsidiaries in a number of other countries of Latin America. The Canadian Montreal Company has operations in at least three other countries of Latin America besides Mexico. Of the three most important private electricity companies in Mexico just mentioned, The Mexican, Light and Power Company is by far the most important and produces and distributes approximately 50% of all the power consumed in Mexico. The three companies do not compete with each other, as their operations are limited by concessions to areas which do not overlap. The Federal Power Commission, the official agency of the Mexican Government, is rapidly and constantly increasing its production as demand for power in areas not served by private companies, is increasingly rapidly growing, and there has, up to now, been no initiative for new private companies to enter the field.
in these new areas. The basic policy of the Mexican Government through the Federal Power Commission up to now has been that this government agency will not compete with the private companies but operate in other areas, and in the areas in which the private companies are operating will aid them in certain ways in carrying through their obligations and in supplementing them when necessary.

There has been a very great change in the electricity situation in Mexico since 1948, due to the more understanding and adequate treatment given by the Government and the regulatory agencies to the private industry. If, as there is every reason to believe, the report of the Government commission studying the electricity situation in the country, is constructive and lays the basis for further constructive and reasonable treatment of the private electricity industry, and the provisions of the report are appropriately implemented by changes in the electricity law of 1939 by the Congress during the session beginning on September 1st, 1955, there is every reason to believe that the electricity situation in Mexico will be consolidated and a completely firm and sound basis will be laid for the providing of the elements and conditions through which power will be available in the central area and other parts of Mexico as the need for it develops. During this period beginning 1948, great forward steps have been taken in implementing and in a measure consolidating the situation. The profoundly useful effects of this policy of the Government are demonstrated by the fact that the continuing industrial and general development of the economy of the country has not been hampered by lack of power. It is significant that, while this electricity problem exists in every country of Latin America, the central area of Mexico is the only comparable area in Latin America in which today any industrial, commercial or domestic consumer who needs power can secure it without delay and has assurance of foreseeable needs for existing and new industries being met. The two other comparable areas so far as economic importance in Latin America is concerned, -- the Rio de Janeiro/Sao Paulo area and the greater Buenos Aires area -- suffer from lack of power and certain restrictions on the use of power.

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