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Transportation infrastructure in Mexico:

The next structural reform

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During the last two decades, Mexico has enjoyed macroeconomic stability, a growing and strong peso-debt market, an open and competitive market for developers and construction companies and three governments with clear infrastructure commitments and professional teams to develop toll roads, railroads, airports and ports. Despite those favourable conditions, the country lags behind many other countries in the development of infrastructure. So what challenges does Mexico face in trying to accelerate development?

Both corruption and insecurity have to a certain extent impaired Mexico's development. Recent geopolitical and economic events threaten to affect this period of stability that the country has enjoyed. Mexico, today, faces a serious challenge. Any adverse effect on Mexico's international trade and foreign investments could seriously cripple the Mexican economy. If any of these adverse changes occurs (especially in regard to the Mexican trade relationship with the U.S), Mexico would need to become substantially more competitive in order to sustain economic growth. However, the institutional, legislative and regulatory regime governing transportation infrastructure projects and logistics has discouraged its development in those areas.

Mexico's legal framework for transportation faces tremendous challenges. Many of the country's laws governing the industry were enacted at the beginning of the 1990s and, although at first helpful, they have since become out-dated and rigid. This legal regime has now created an unprecedented institutional backlog. The current public works statutes (with their numerous amendments), the general regime for concessions and the institutional framework (which is overseen by the Ministry of Transportation and Communications (SCT, for its Spanish initials)) have now proven to be inadequate to satisfy the needs of a growing economy.

In our view, the sector's legal and institutional framework warrants a deep review, and demands the creation of one or more new *ad hoc* regulatory bodies with clear power and authority. These bodies should be politically independent, be comprised of specialised professional teams and be tasked with adopting policies that embrace best practices in the areas of project planning, design, contracting and project management. These changes are aimed at reducing institutional restrictions, fostering transparency and promoting the development of projects in an organised and efficient fashion. We also suggest a review of the legal framework of concessions and the use of the recently enacted PPP statutes and regulations.

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Mexican transportation infrastructure evolution

NAFTA came into effect in 1994 and led to changes in the legal framework in Mexico in many areas, including the transportation industry. These changes were built on three main pillars: legal reforms to enable private investment; private sector participation in the development of infrastructure projects through concessions; and the privatisation of ports, airports toll roads and railways that, until then, had been owned and operated by the federal government.

To illustrate the benefits brought about by these changes, one needs only turn to the performance and improvement of the airports that are operated by the three major airport groups in Mexico. Each of these groups took on the airports that were adjudicated to them and executed rolling five-year investment plans with no delays. To date, all three operate airports under the best international standards and remain profitable.

These projects and similar ones in the railway, toll road and port sectors marked a turning point in the offering of public services. They enabled better communications and resulted in a significant amount of new investments. Furthermore, these actions were widely applauded by the international community. Mexico's infrastructure growth over the last three governments has been, largely, the result of those reforms and the concession scheme they created.

With more national and foreign investment coming in, modern project finance structures for infrastructure projects were required. Until then, most project finance was done through state funding or public debt. For the first time, the public works financing schemes were competing with international and sophisticated project financing structures. Two key factors boosted this change: first, for the first time private firms were allowed to act as concessionaries of public infrastructure, and second, the public finance scheme was no longer sustainable. In order to maintain a low foreign debt economic plan the government and the developers assessed the costs and benefits of public financing against private project financing. Public debt will always be cheaper given the low-risk exposure for the lender; however, the private project financing schemes offer other benefits, including risk allocation, innovative financing structures, the creation of secondary markets and low capital costs.

Mexican officials are aware of the importance that infrastructure has in the country's development. During the last three administrations, the National Infrastructure Plan has been a key component in the planning and development of infrastructure in Mexico. However, in stark contrast to the benefits described above, the legal framework soon showed its shortcomings. A large number of infrastructure projects were originated and launched, but many were eventually cancelled or their bidding processes never started. Many others were completed with significant delays and cost overruns. This lead to time consuming and unproductive renegotiations that increased transactional costs for the government, the concessionaries, and other third parties involved (i.e. the banks that provided the financing for the project).

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These problems are illustrated by the two largest and possibly most complex toll road projects in the past two decades; the Durango-Mazatlán and the Mexico City-Tuxpan east-west corridors. The former was developed through a public works contract, while the latter was developed through a mix of different concessions granted to the private sector. None of the applicable pieces of legislation (which vested authority over all phases of these projects upon the SCT) helped solve the complex issues in the development of such projects.

Given the agglomeration of powers vested by the applicable statutes into the SCT, this entity found itself overworked, delaying the projects and delaying their financing. Both projects suffered from all the familiar problems faced by many large and complex projects worldwide. Additionally, each project was also supervised by the Mexican Ministry of Public Controllership and the Mexican Federal Superior Auditor of Congress. However, because these authorities essentially are financial auditing entities, they lacked sufficient expertise in project development. This lack of expertise severely affected the construction of, and ultimately the costs associated with, these projects.

Other deficiencies in the legal framework were clearly seen in the port sector. Integral Port Managers (Aministradoras Portuarias Integrales or APIs), the cornerstone of the legal framework necessary to develop the Mexican port industry, failed to meet expectations due to a lack of a clear scope of authority. Established as a contractual framework to involve the private sector in the management of Mexican ports, its enabling statute permitted the assignment of management rights to private companies. However, the assignment of management rights required the intervention of at least four different levels of authority within the SCT. Additionally, the lack of funding and capital resources at the APIs, as well as the lack of planning during their initial stages, led to real estate speculation in their surrounding areas, which affected growth opportunities in those areas. In turn, as the need for larger and more competitive ports grew, these deficiencies restricted their competitiveness and efficiency.

Growing pressure from the national and international private sector drove the Mexican government to turn to Public Private Partnerships. In 2012, the Mexican Congress enacted the Public-Private Partnership Act, which once again created a momentum among investors reminiscent of the 1990s. The expectations generated by the new statute led the industry to anticipate a new wave of infrastructure development. However, these expectations were not realized. Since then, PPPs have been seldom used in the development of transportation and logistics infrastructure. One reason may be the lack of an adequate institutional framework; another can be restrictive regulations for public officials.

In light of these circumstances, the current government departed from the traditional patrimonial concept of public goods and public services and embraced a novel, inclusionary vision (publicized as "An Inclusive Mexico," "A Connected Mexico" and "Moving Mexico"). Inclusion or availability of infrastructure and means of transportation for a greater majority of people and goods in the most efficient manner seemed to be the new end-game, in contrast with the old vision where the state was responsible for providing services by relying on the somewhat restrictive and problematic concession and service contract regimes.

With this refreshing new vision, the current government launched its National Infrastructure Plan. Nonetheless, during its implementation and execution stage the government reverted to public works and state financing, instead of turning to the newly enacted PPP statute. Two of the most iconic projects of the current government, the Mexico City- Toluca Railroad and the New Mexico City International Airport, have faced delays and cost overruns. Unfortunately, these issues are nothing new. The legal framework creates bottlenecks because the responsibilities and roles of both parties (private and public) are unclear and often used as a bargaining chip. These bottlenecks, along with the lack of an efficient and continuous plan have led to incredible cost overruns. Although some of those projects have begun, we fear that the Mexican government once again finds itself in a difficult position to complete all of the promised projects on time and on budget.

Finally, with respect to the management of transportation assets by the government, little if anything has changed in the last several decades. State-owned entities like CAPUFE (the toll road state owned manager), ASA (the state owned airport manager), several federal and local APIs as well the Ferrocariles del Istmo de Tehuantepec, continue to underperform the private sector. In this regard, there has not been any clear action from the government to improve their financial performance, quality or efficiency.

These shortcomings are nothing new to Mexican legislators and public officials. As part of the energy reform of 2013, the Mexican Congress amended the Mexican Constitution to include the concept of Productive State Companies (or EPEs for their initials in Spanish). As one of the main actions to save an agonizing PEMEX (the oil state owned company), both the government and the legislators created a unique type of public entity which incorporates the best practice principles of corporate governance into state-owned firms.

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Centralisation of functions by the SCT

Congress and political leaders have always allocated planning, designing, regulatory, supervisory, contracting and management powers to the SCT in order to have a centralised control of infrastructure. However to analyse the performance that the SCT has had in its functions, one can look at the Mexican rankings in competitiveness made by the World Economic Forum. Mexico ranks on the 2016-2017 competitiveness report as number 51 in competitiveness overall, below other countries in the region such as Panama and Chile. Although a significant improvement from previous years, a look over the basic requirements for growth such as institutions and infrastructure are discouraging. Mexico ranks as 116 of 138 in its institutions and 57 in infrastructure; with corruption, inefficient government bureaucracy and inadequate supply of infrastructure as 3 of the main problematic factors for doing business, according to the World Economic Forum.

The centralisation of powers in the SCT has raised risks to private sector participants. According to a study conducted by the Mexican Federal Superior Auditor of Congress in 2014, the main cause of cost overruns in infrastructure projects is the lack of efficient planning. The private sector often has to renegotiate previous agreements with new governments or seek their enforceability without any success. In addition, staff changes at the SCT with the turn of each government reset the learning curve every six years (at best).

Another important aspect that warrants reviews is our contracting framework. Mexico, like many other countries in the region, has relied heavily on concession agreements with only few exceptions. However, due to a lack of planning or specialised and realistic designs and forecasts, as well as the long terms for which they are awarded, concession provisions are often (if not always) incomplete or unrealistic. The majority of them end up being renegotiated (especially in terms of costs and maturity) in an often lengthy process with the SCT and/or other federal entities or local authorities.

With a notorious absence of alternative and efficient dispute resolution provisions, conflicting incentives over non-recoverable expenses for both parties and the lack of compliance with international best practices; the Mexican concession scheme has become very expensive one. Moreover, our regulation of these "contractual" provisions is almost non-existent. Often the modern practice, where boilerplate concession templates from previous projects are used for new and different projects has undermined the existing relationship with the government and the concessionary. In a nut shell, we turned to building first and regulating after, with no efficient planning whatsoever.

In spite of these problems, concessions can be helpful if managed properly and with a right institutional framework. These two conditions are key factors for any project to be successful. Empirical studies like those conducted by José Luis Guasch have proven that concessions tend to be renegotiated in most cases. In his study, Guasch concludes that 55% of concession contracts regarding transportation infrastructure granted in Latin America and the Caribbean between 1982 and 2000 had been renegotiated. He stresses (and we agree) the importance of proper planning, tailor made realistic concessions and a strong and efficient institutional framework.

It seems that both Congress and the federal government have recently taken these considerations into account. A new reform on the infrastructure framework now requires the Mexican Ministry of Finance to be involved in renegotiations. The energy reform enabled a bigger participation from the private sector and has definitely attracted investors from all over the world. However, the main institutional and contractual aspects of transport infrastructure regulation remain outdated, untouched and inefficient.

A proposal to review the institutional and contractual framework

In spite of a recent set of structural reforms, both the Mexican Congress and the Mexican government have left the transportation infrastructure legal framework untouched. Mexico now finds itself at a crossroads between seizing its opportunities and lagging behind. We believe that an institutional reform needs to take place.

The centralization of powers into one large government secretary is no longer sustainable. We also believe that there are a lot of well-prepared and efficient public officers that are constrained by bureaucratic regulations and politicized decisions. Today, the SCT is a behemoth of power, with its tentacles spread over every aspect of transport, with such broad authority and oversight over so many industries that it lacks the required specialisation for a modern and long term projects. However we are also aware that a governmental regulator is imperative. Consequently, our intention is to open the discussion for the creation of one specialized entity that will remain politically impartial and will continuously specialize itself to meet modern industry and economic demands. This new specialized entity would co-exist with the SCT, which would remain as a pure regulating and supervision agency.

This governmental structure is not new neither to the Mexican Government or the SCT. As part of the energy reform, the Mexican Congress separated regulatory, supervision, contracting and management powers among the Secretary of Energy, the Federal Electricity Commission and PEMEX. The SCT, in turn, currently has a similar system of allocation of powers in telecommunications between the Federal Telecommunications Institute and itself.

Consequently we suggest that new structures such as the EPE or productive state owned companies are used to create that institution. The idea is for it to remain as isolated as possible from the changes that occur due to change of administrations or politics. This new entity would take over specialised long-term planning in order to meet current and new, ever-changing necessities. By remaining impartial, the entity's officers would be able to make decisions without considering political costs or influences; become a competitive place to attract well prepared and specialized staff and to better approach the industry's needs. In doing so, we believe that these advantages could provide an important step in becoming more competitive in infrastructure, institutional framework and logistics. Given the level of specialization we also believe that transactional costs and learning curves could be decreased significantly, resulting in a better performance for both the government and the industry.

Finally, we suggest a larger migration from the old concession and public works schemes to PPPs. We believe it is necessary to revisit the current legislation in order to enable public officers to have more technical and financial flexibility in assigning and structuring the projects. Mexico has a regulation in effect that enables the development of projects under such a structure, but it still lacks the necessary institutional framework and dynamic flexibility that encourages decision makers to use this scheme. We strongly believe that a partnership with a specialised entity, instead of the politicised bureaucracy that exists today, will be a key element in our ability to grow our infrastructure and incentivise investors.

Mexico remains a country of opportunity, hard work, and incentives for investors and enormous growth opportunities. We strongly believe we are just in time to take advantage of those opportunities by continuing in a path of change in order to overcome its challenges.