CLIENT UPDATE

A STEP BACKWARDS: AMENDMENTS TO ELECTRICITY LAW ENACTED BY MEXICAN PRESIDENT

Electricity Reform

An electricity reform implemented by Mexico in 2014 (the "Electricity Reform") opened substantial portions of the Mexican electricity market to competition and innovation. It provided that the Mexican Government should execute agreements with Mexican and foreign companies for generation, supply and distribution of electricity by such companies.

The new legislation set forth the main criteria under which Mexican and foreign companies might participate in bidding processes to provide transmission and distribution services. Under the Electricity Reform, the Mexican Government remained responsible for such services, with the joint liability of the companies to which a transmission and distribution project is awarded under a public bidding process.

Mexico committed to a climate change policy that was given effect as both, environmental policy and energy policy. The reform established set goals mandatorily defining the extent to which Mexico should rely on clean renewable energy to meet future electricity supply needs.

The National Center for Energy Control ("CENACE") was charged with implementing a change from a scheme that controlled market power exercise by utilities, pipelines and producers through classic monopoly rate regulation to a regulatory regime that would control the exercise of market power through reliance on a mixture of competition and regulation so as to seek to achieve just and reasonable rates.

Regulatory and enforcement powers granted by the reform were very significant. Specifically, provisions mandated open access to the production, transmission and distribution system and granted the Ministry of Energy ("SENER") discretionary authority to define manipulation by rule or order, prevent market power exercise, issue orders to seek open access to the relevant system and require dissemination of information that would improve transparency of wholesale markets

The new legislation established the basis to foster the production and consumption of electricity produced from renewable sources in response to concerns over energy independence, climate change and the disappearance of fossil fuels. Such basis required an electric utility, electric provider and designated consumers to produce or purchase a specified percentage of electricity from renewable energy sources. Implementing measures included clean energy certificates ("CECs"), among others. CECs were issued by the Energy Regulatory Commission (the "Commission") for sale in the wholesale market, to allow a producer or retail electricity provider to produce or purchase a specified percentage of electricity from renewable energy sources. CECs are instruments representing the environmental attributes of renewable energy that may be traded separately from the energy itself. Electricity suppliers may comply with the new legislation by (i) owning a renewable energy facility (with a designated capacity) and its production, (ii) purchasing CECs, or (iii) purchasing electricity and the accompanying renewable attributes from a renewable energy facility. SENER specified the rules for the issuance of such certificates, which was timely launched.

Implementing legislation entrusted CENACE with the approval of SENER, to conduct open bidding processes to purchase electricity in the wholesale market.

The policy embodied in the Electricity Reform was intended to create competitive pressures so as to improve efficiency, reduce costs, and lower wholesale power prices.

The state-owned electric utility *Comisión Federal de Electricidad* ("CFE") was required to conduct open bidding processes to execute agreements with private companies to conduct activities relating to such utilities. Restricted bidding processes or direct awards were permitted in certain instances.

The new legislation charged SENER with issuing the rules pursuant to which private parties and some state-owned corporations should be entitled to obtain licenses to develop renewable energy sources for public power production. Such sources included, among other, wind, solar, geothermal, waste utilization and hydrokinetics (use of waves, tides and currents to generate electricity) projects.

Steady progress was made in the implementation of the Electricity Reform and a new electricity market was successfully started in Mexico. Foreign and Mexican firms intensified a much-needed moving forward of investment in the sector.

Change in Policy

A new Mexican president, Andrés Manuel López Obrador ("Amlo"), was sworn in on December 1st, 2018.

The new Federal Administration characterized the electricity reform as one of the "neo-liberal measures" adopted by previous administrations. It started implementing a number of

administrative measures aimed at reverting back the electricity market to a previous model of classic monopoly controlled by CFE.

Such administrative measures were challenged in Mexican courts, including an action instituted by the Federal Economic Competition Commission (*Comisión Federal de Competencia Económica*—COFECE) against SENER measures.

The Mexican Federal Supreme Court rendered a decision on February 4, 2021 finding the main piece of such administrative measures unconstitutional. The Supreme Court ruled that the regulations entitled "Quality, Continuity, Safety and Reliability Policy of the National Electricity System" issued by SENER in 2020 violate the Mexican Constitution by displacing competition by private producers, particularly those producing electricity from renewable sources (clean energy).

The Supreme Court stated that while SENER has legal authority to make energy policy, such policy may not contradict or override existing constitutional principles. The Court ruled that the challenged regulations curtailed freedom to participate, open competition and climate protection provisions, including those found in articles 28 and 25 of the Mexican Constitution.

Other legal actions have challenged regulations issued by related agencies with similar objectives and have so far resulted for the most part, in court rulings adverse to such agencies. A number of such rulings are currently under review by higher federal courts.

Mindful of the possible outcome of the Supreme Court decision mentioned before, the Federal Administration introduced a bill of amendments to electricity legislation with a similar purpose to that sought by the struck-down regulations: to undo fundamental pieces of the Electricity Reform.

Proposed Bill

On January 29, 2021 the Mexican President submitted a bill to the Mexican Congress to amend the Electricity Industry Law (*Ley de la Industria Eléctrica*; the "Bill") to, among other: (i) modify the dispatch order of power plants to favor CFE in the dispatch order; (ii) allow legacy power plants (i.e., those operating before the Energy Reform) to receive CELs for power generated; (iii) allow CFE to purchase power directly from market participants and not exclusively from public energy bids; (iv) allow the Commission to terminate certain existing legacy self-supply permits; and (v) allow CFE to renegotiate or terminate existing power purchase agreements executed with independent power producers for certain legacy projects. The Bill was submitted on a preferential treatment track, meaning that it was discussed and voted on by the Chamber of Deputies (*Cámara de Diputados*) within 30 days from its submission.

On February 23, 2021, the Chamber of Deputies acting in haste (in 17 hours, without the benefit of expert testimony of any kind, and despite 412 reservations made to the text of the bill) discussed and approved the Bill in its original form. The Bill was delivered to the Senate and approved on March 2 after a perfunctory discussion of the same. The Mexican President enacted the Bill into law on March 9, 2021 (the "Amlo Amendments").

Potential Consequences

Despite the lack of continuity in the Federal Administration's policies applicable to the energy sector, Mexico's need for new energy infrastructure has continued to grow. For instance, CFE recently announced its business plan for 2021–2025, which includes the development of more than 4,347MW—mostly through combined cycle facilities—amounting to a total investment of US$3.1 billion. Also, CFE further announced that it is analyzing a possible investment of US$600 million for the development of 500MW of renewable energy power plants. This potential expansion of CFE's renewable power portfolio took the market by surprise, given that the head of the CFE, Manuel Bartlett, has strongly criticized the intermittency and reliability of renewables projects. It may also further undermine the Federal Administration's stated justifications for actions taken previously that are harmful to private renewable energy companies and expose those actions, subsequently reflected in the Amlo Amendments, to claims that they are indictments on private investment.

The Mexican think tank *México Evalúa* estimates that the Amlo Amendments will result in increased polluting emissions, and also—contrary to statements made by the Federal Administration—will require the government to raise electricity rates or spend more on residential electric subsidies (which were already approximately $3.7 billion in 2020).

The Amlo Amendments will cause a major unilaterally-induced change of circumstances in respect to the basis upon which Mexico invited Mexican and foreign investors, to invest in Mexico's electricity market, as reflected in the Electricity Reform.

Unilaterally-induced Change of Circumstances

Mexican law provides that the content of an obligation cannot be left to the will of one of the contracting parties. Based upon such provision, unreasonable changes made by a governmental entity to the basis under which an investor was invited to enter into a contract, may provide a basis to either excuse such investor from performing under the contract or enable the filing of a claim for damages against such governmental entity. [1]

[1] Civil Code for the Federal District (*Código Civil para el Distrito Federal*), art. 1797. Primer Tribunal Colegiado en Materias Administrativa y del Trabajo del Décimo Primer Circuito. Décima Época, Registro 2016332, Tribunales Colegiados de Circuito, Jurisprudencia, Gaceta

2019 foreign arbitration awards provide guidance as to the scope of treaty protections as the same apply to the protection of legitimate expectations. One of the key points of contention has been the interplay between a country's right to regulate and investors' expectation of stability. Some tribunals have found that while a treaty does not bar a host country from making changes to the existing regulatory regime, it did oblige countries to "protect investors from a fundamental change to the regulatory regime in a manner that does not take account of the circumstances of existing investments made in reliance on the prior regime." As a result, investors had a legitimate expectation that the regulatory regime upon which their investments were based would not undergo a "total and unreasonable change."[2]

Such precedents would appear to coincide with the fundamental rule of Mexican law mentioned before, that the content of an obligation cannot be left at the will of one of the contracting parties, the same being in this instance a governmental entity. It would appear thus, that a foreign arbitral award or judgement rendered upon such basis, should be either enforced upon assets of the governmental entity outside of Mexico, or recognized and enforced in Mexico, provided it would not violate a provision of Mexican law embodying public policy.

Under the United States, Mexico, Canada Agreement ("USMCA"), investor-State arbitration is limited to the United States and Mexico. Access to ISDS (USMCA's Investor-State Dispute Settlement ("ISDS") provisions for disputes between Canadian or Mexican investors and Mexico or Canada, respectively, is possible under the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (the "CPTPP"), which entered into force on December 30, 2018.

Under the USMCA a priority regime applies to foreign investors that are "party to a covered government contract" and belong to five "covered sectors": (i) oil and gas; (ii) power generation; (iii) telecommunications; (iv) transportation; and (v) infrastructure. Investors under this priority regime can enforce substantially the same investment protections available under NAFTA through the USMCA's ISDS procedures. Fundamentally the same jurisdictional requirements and waiting periods that applied under NAFTA will apply to the USMCA to priority disputes.

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del Semanario Judicial de la Federación, Libro 52, Marzo de 2018, Tomo IV, Materia Administrativa, Tesis XI.1o.A.T. J/15 (10a.), pág. 3087.

[2] See: NextEra Energy Global Holdings BV and NextEra Energy Spain Holdings BV v. Kingdom of Spain FET 2013–2014 31 May 2019; 9REN Holding S.à r.l. v. Kingdom of Spain FET 2010–2014 31 May 2019; Cube Infrastructure Fund SICAV and others v. Kingdom of Spain FET 2013–2014 15 July 2019; SolEs Badajoz GmbH v. Kingdom of Spain FET 2013–2014 31 July 2019; InfraRed Environmental Infrastructure GP Limited and others v. Kingdom

Ongoing NAFTA arbitrations will continue under the same. In addition, investors will be able to file new NAFTA claims within three years of NAFTA's termination, provided the dispute arises out of "legacy investments". "Legacy investments" are investments that were "established or acquired" while NAFTA was in force and that remained "in existence" on the date the USMCA entered into force.

As mentioned before, as part of the Electricity Reform, Mexico required off-takers in the wholesale electricity market, including the CFE, to acquire CELs.

Under measures adopted last year, SENER changed the eligibility criteria to allow older projects developed by CFE to obtain clean energy certificates; and as a consequence, reduced the value of the certificates, a change which is being challenged in courts.

A number of provisions included in the Amlo Amendments and its negative impact on clean energy projects, may well implicate Mexico's obligations under USMCA and other international agreements, and allow investors to pursue arbitration so as to enforce investment protections available under the same.

Investors should carefully review the alternatives available to them with the assistance of legal counsel, in view of the change of circumstances induced by the Amlo Amendments. Such alternatives are likely to include arbitration under one of the array of trade and investment treaties entered into by Mexico, including USMCA (and NAFTA), CPTPP as well as bilateral treaties. A possible action before Mexican courts should also be factored into such analysis.

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Please do not hesitate to contact us with any questions.

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