CLIENT UPDATE

THE ENERGY REGULATORS' EXPANDED POWERS COMPLICATE OPERATIONS OF CURRENT AND NEW PERMIT HOLDERS

Energy Reform

An energy reform implemented by Mexico in 2014 (the "Energy Reform") opened substantial portions of the Mexican energy industry to competition and innovation.

The new legislation empowered the Mexican Government, through bidding and licensing processes, to execute agreements with both private and state-owned Mexican and foreign companies, so that such companies may undertake in Mexico the exploration and production of oil and natural gas, subject in each case to certain controls and restrictions. Rather than operating as monopolies, the state-owned companies would need to compete with private companies in bidding rounds, signing agreements with the Mexican Government only if successful.

Steady progress was made in the implementation of the Energy Reform and a new energy industry started developing 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 Energy Reform as one of the "neo-liberal measures" adopted by previous administrations. Under an approach similar to that utilized in respect to a parallel electricity reform, it started implementing a number of administrative measures aimed at reverting back the energy market to a previous model of classic monopoly controlled by Pemex.

As a first step, the Amlo Administration suspended planned bidding rounds on the basis of which private and state-owned Mexican companies, would compete to undertake the exploration and production of oil and natural gas. Other administrative measures geared in the same direction followed.

Such administrative measures were likely to be challenged in Mexican courts as unconstitutional, since the same may not contradict or override existing constitutional principles.

Mindful of the possible outcome of court decisions on the matter, the Federal Administration introduced a bill of amendments to energy legislation with a similar purpose to that sought by the above-mentioned administrative measures: to undo fundamental pieces of the Energy Reform.

Amlo Amendments

After a perfunctory discussion and approval of the same by the Mexican Congress, the Mexican President enacted the bill of amendments to energy legislation into law on April 29, 2021 (the "Amlo Amendments"). The Hydrocarbons Law (*Ley de Hidrocarburos*) was amended to, among other: (i) suspend or terminate existing permits that pose an imminent treat to national security, energy security or the national economy; (ii) rescind permits where storage requirements to be dictated by the Ministry of Energy (*Secretaría de Energía*, "SENER") are not met; (iii) allow authorities to occupy and operate premises in respect to which permits have been suspended or terminated; (iv) allow SENER and the Energy Regulatory Commission (*Comisión Reguladora de Energía*, "CRE") to terminate suspended permits after summary administrative proceedings of 15 days.

Potential Consequences

Risk-sharing contracts permitted under the 2014 Energy Reform are viewed as essential for a Mexican energy rebound. A steep decline in Mexico's crude output has forced a quick shift from oil to natural gas dependence, among other in the power sector, according to IEA. But since the vast majority of Mexico's own gas production comes as "associated" to crude, domestic gas supply has been falling just as fast as oil. After seven years of supposed increased competition, private players account for just five percent of Mexico's gas production.

Mexico should utilize its world-class solar resource to diversify the power portfolio and meet climate goals under the Paris Agreement. The Amlo Administration, however, has been canceling clean power auctions for private developers in favor of natural gas, blaming "intermittent" renewables for recent large outages.

Notwithstanding the above, the private sector remains interested for the time being in the country, having mentioned a $92 billion investment package to Amlo last year. However, it is

essential to provide certainty and predictability for such plans to materialize. The Amlo Administration is seeking wins this summer in the regional and congressional elections, in order to change the Constitution and try to revert the Energy Reform.

The Federal Administration claims that the Amlo Amendments target fuel theft and contraband, which are problems that need an immediate response. However, the package paves the way for interpretation that may reduce competition.

The Amlo Amendments toughen the rules for private companies to request and keep permits to among other, import, export, transport and distribute liquid fuels in the country.

The Amendments also open the possibility of a company losing its permit if its operations are deemed an "imminent threat" to national security or energy security, concepts which are less than entirely clear. The Amendments allow Pemex to take control of the assets of those companies that lose their permits.

Constitutional Implications The Amlo Amendments may be construed as contradicting constitutional principles of free competition, establishment of clear criteria for the exercise of discretionary powers and prohibition of retroactive (*ex-post-facto*) application of the law.

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]

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,

[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 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.

investors had a legitimate expectation that the regulatory regime upon which their investments were based would not undergo a "total and unreasonable change." See page 5 in here

http://berdeja.com.mx/memos/A%20Step%20Backwards-%20Amendments%20to%20Electricity%20Law%20Enacted%20by%20Mexican%20President.M16C.21.pdf

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.

Subject to the way de Amlo Administration interprets the same, a number of provisions of the Amlo Amendments may well implicate Mexico's obligations under the United States, Mexico, Canada Agreement ("USMCA" and NAFTA), the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (the "CPTPP") and other international agreements, and allow investors to pursue arbitration so as to enforce investment protections available under the same.

Should energy regulators adopt a broad interpretation of the Amlo Amendments, investors should review the alternatives available to them with the assistance of legal counsel. A possible action before Mexican courts should be factored into such analysis, carefully calibrating arguments to be used, so as to avoid a repetition of the same in a possible arbitration under one of the trade and investment agreements, which may in some instances, foreclose the possibility of arbitration. Another alternative would consist of 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.

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Please do not hesitate to contact us with any questions.

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