Energy Reform

Electricity reform and international treaties

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8 April 2022

The reform of the Electricity Industry Act approved in 2021, as well as the draft constitutional reform that seeks to make it viable, are in clear violation of Mexico's international commitments in trade and investor protection treaties. This increases the cost (in compensation and trade reprisals) of an initiative that, if approved, would undermine investor confidence in the country, while producing more expensive and polluting electricity, harming all economic activity, households and the treasury.

Reform of the Electricity Industry Act 2021

On March 9, 2021, the Decree amending and adding various provisions to the Electricity Industry Law (LIE for its acronym in Spanish) enacted in 2014 was published in the Official Journal of the Federation (OJF); this reform, among other aspects:

- Amends the dispatch criteria to the National Electric System, giving priority -not to the lowest cost energy[1]- but to the Legacy Power Plants (owned by CFE, the state-owned electric utility) with a commitment to the physical delivery of energy (non-renewables).
- Without being explicitly stated in the legal text, the findings of the project indicate the following dispatch order:
  - CFE hydropower plants
  - CFE nuclear, geothermal, combined cycle and thermoelectric power plants and those independent power plants that supply CFE under contract
  - private wind and solar power plants[2], and
  - combined cycle power plants and other private power plants.
- Eliminates the obligation of CFE (as the sole Basic Services Supplier) to purchase electricity through auctions organized by the National Energy Control Center (CENACE for its acronym in Spanish), allowing direct negotiation and contracting between CFE and the generators.
- Makes power plants that started operations prior to the 2013 reform (notably CFE's hydroelectric, geothermal and nuclear power plants) eligible for the issuance of clean energy certificates (CECs)[3].
- It establishes that the issuance of permits by the Energy Regulatory Commission (CRE for its acronym in Spanish) must now be subject to the planning criteria of the Secretariat of Energy (SENER for its acronym in Spanish)[4] and adds that interconnection to the National Transmission Network and the General Distribution Networks will be provided when "technically feasible".

1: The LIE originally established that dispatch must be carried out based on criteria of safe dispatch and economic efficiency.
2: Renewable generation plants are lagging behind by virtue of the priority given to Electricity Coverage Contracts with Physical Delivery Commitment, which wind or solar producers cannot access due to the intermittency of their generation.
3: This measure would result in an increase in the number of CECs in circulation, making them cheaper and thus reducing the incentives for investment in renewables which was the raison d'être of the scheme.
4: Such planning criteria shall be in accordance with the "Reliability Policy" published in May 2020, which limits the interconnection of "Intermittent" Clean Energies in order to ensure the reliability of the electricity system and security of dispatch.

- Cancels self-supply permits granted by the CRE under the sector's previous scheme[5] that were granted in violation of the law (abusing the generation system originally designed for self-supply).
- In the same vein, it establishes that the legality and profitability criteria for the federal government of the legacy independent production permits will be reviewed.
- Establishes the exploitation of lithium as an exclusive activity of the Mexican State.

Judicial injunctions and unconstitutionality action

As a result of a series of amparo lawsuits filed to challenge the unconstitutionality of the LIE Reform Decree, the First and Second District Courts on Administrative Matters, Specialized in Economic Competition in Mexico City, ordered several final injunctions against the decree.

The final injunctions were granted with across-the-board effects, in order to avoid granting a competitive advantage only to certain entities, thus avoiding distortions in the electricity industry and affecting competition and the development of the sector.

The authorities appealed these injunctions before several District and Collegiate Circuit Courts, which granted the revocation of several, however, the Supreme Court of Justice of the Nation (SCJN) ordered the suspension of the proceedings until the resolution of the action of unconstitutionality filed by various Senators.

On April 7, 2022, the SCJN finally resolved the matter, reaching only 7 votes in favor of the unconstitutionality of the Act regarding the dispatch of electricity and environmental considerations, not the 8 necessary to establish a binding precedent, to be followed on all courts.

This leaves the door open for the pending amparos, as well as those that accumulate, to be resolved case by case, giving full freedom to the District Judges and Collegiate Courts to issue the sentences, and ultimately to be resolved in the chambers of the Supreme Court itself; where, considering the recent vote -and the fact that these sentences are reached by simple majority- they would have a high probability of succeeding. It is precisely for this reason that the government will seek to move forward with its constitutional reform.

Constitutional reform initiative

On October 1, 2021, the Executive submitted an initiative to reform Articles 25, 27 and 28 of the Constitution to the Chamber of Deputies. It sought to address the legal obstacles faced by the administration's energy policy and to consolidate its vision for the sector once and for all.

The main elements of the constitutional reform project are as follows:

- To establish electricity as a strategic area and to exclude the activities carried out exclusively by the State in this industry from the definition of monopoly (expanding the current provisions, which only refer to "the planning and control of the national electricity system" and the public service of transmission and distribution of electricity).

5: Electric Energy Public Service Act.

- It converts CFE into a government agency (no longer a "productive company") responsible for the National Electric System (SEN for its acronym in Spanish) and its planning and control (functions currently performed by CENACE, which would be reincorporated into CFE). As a further measure, it eliminates the legal separation of its subsidiaries and affiliates, thus eliminating their independent participation in the different activities of the sector.
- It establishes that the CFE will generate at least 54% of the electric energy, leaving the private sector no more than the remaining 46%, subject to what the CFE determines in its role as entity responsible for the SEN.
- The cancellation of existing permits and contracts for the generation of electricity and electricity purchase and sale contracts is foreseen, in a retroactive application of the law; likewise, the various forms of private generation and self-supply permits obtained illegally would be canceled.
- It eliminates the obligation of CFE to purchase energy through auctions organized by the CENACE, allowing direct negotiation and contracting between the generators and the Commission.
- It cancels the CEC mechanism, market-based instruments introduced to incentivize investments in clean energy.
- It removes the CRE and the National Hydrocarbons Commission -agencies with technical and managerial autonomy- and assigns their structure and functions to the Secretariat of Energy.
- It establishes that the State will be in charge of the "Energy Transition" and will use available energy sources in a sustainable manner in order to reduce greenhouse gas emissions. It assigns CFE the responsibility of executing the electricity Transition.
- The minerals considered strategic for the "Energy Transition", including lithium, will be exploited exclusively by the Nation, and cannot be granted in concession.

Implications for International Treaties

The electricity reform initiative, under the terms presented, in addition to the severe legal and economic repercussions that it would bring to the country, contains several aspects that are incompatible with Mexico's international commitments[6]:

- The appointment of the CFE as the state agency responsible for the strategic area of electricity, in charge of the control and planning of the system (currently entrusted to CENACE) would concentrate the bulk of electricity generation and the regulation of the sector to a single agency, making the CFE both judge and party in the industry.

  In effect, the arbitrary allocation of at least 54% of the market to CFE, as well as the implications that the constitutional decree would have on the dispatch order (priority to CFE and the relegation of renewables), would give the Commission a dominant position in the market (in addition to its control and planning), a situation that is incompatible with the competitive expectations set forth in international treaties prohibiting the granting of preferential treatment to a local company over those of other signatory countries.

  In addition to the above, the requirement to purchase electricity through auctions (a transparent and competitive scheme) and the vertical and horizontal integration of CFE (which reduces transparency and reintroduces cross-subsidies, generating inefficiencies and assigning it market power), have been abandoned

6: Mexico is the signatory of 13 Free Trade Agreements and 30 Agreements for the Promotion and Reciprocal Protection of Investments (APPRIs).

to configure a scenario clearly biased in favor of CFE, and contrary to free competition, the interests of investors and consumers, and the agreed-upon rules of the game.

In this regard, the chapters on State-Owned Enterprises and designated monopolies of both the USMCA and the CPTPP establish that such state-owned companies must act according to commercial considerations in a non-discriminatory manner in their purchases and sales of goods or services, which is clearly incompatible with CFE's intention to limit its purchases of electricity from private parties and to alter the order of dispatch.

Furthermore, the granting of a dominant position to the CFE (both in terms of dispatch and generation, as well as planning and control) clearly disadvantages the participation of private parties in the sector, possibly constituting a discriminatory, unfair and inequitable treatment for investors, with this being incompatible with the requirements of National Treatment and Minimum Standard of Treatment provided for in the treaties.

- The cancellation of generation permits, licenses and contracts in force, considering that these are acts that undermine the legal certainty of investors and violate their acquired rights, contravene fair and equitable treatment (provided for in the Minimum Standard of Treatment clause), and could even be construed as indirect expropriations by diminishing or eliminating the value of the investments.

  Even if Mexico could overcome the illegality of the expropriation on the grounds of public interest, it would still be obliged to pay compensation (the amounts of which would be subject to subsequent challenges) under the dispute resolution mechanisms provided for in the treaties.

- The disbandment of the CRE and the CNH, as well as the absorption of CENACE's functions by CFE, compromises the conditions of impartiality and competition, as opposed to the fair, equitable and non-discriminatory treatment to which they are entitled under international treaties signed by Mexico (Minimum Standard of Treatment and National Treatment).
- In the USMCA, Mexico agreed to strive to ensure that environmental laws and policies achieve high levels of protection and recognized the importance of multilateral agreements on the matter, committing to implement those in which it participates. In this regard, under the Paris Agreement, Mexico pledged to reduce its emissions to achieve 35% clean energy by 2024 and 43% by 2030.

  Although the country is – even before the LIE reform – far from meeting these goals, the cancellation of the CECs and the change to the dispatch order to privilege polluting sources and relegating renewables, directly contravenes the commitments adopted by Mexico and slows down the progress toward these goals by discouraging investment in clean energy projects, not to mention the abandonment of economic criteria for the dispatch order (which, virtuously would favor non-polluting sources).

- The international treaties in force do not include among their non-conforming measures the exploitation of lithium as an exclusive activity of the State. Closing the sector by prohibiting future concessions is again contrary to the rights of fair and equitable treatment (Minimum Standard of Treatment) for investors. Moreover, since it is not a reserved activity, closing it to private capital would be contrary to the ratchet clause, which obliges the parties not to reduce the degree of liberalization existing at the time of signing, but - if anything - only to make amendments that would further liberalize it.

Figure 1. **AREAS OF CONFLICT: REFORM PROPOSALS AND CHAPTERS OF THE TREATIES**

	Chapters of the treaties		
	Investment USMCA 14 CPTPP 9	State-owned enterprises and monopolies USMCA 22 CPTPP 17	Environment USMCA 24 CPTPP 20
CFE as a government agency, responsible for the strategic area of electricity (regulator and party)	X	X	
Amendment to dispatch rules 54% CFE / 46% private	X	X	
Cancellation of power generation permits	X		
Disappearance of the CRE	X		
Cancellation of CECs	X		X
Exclusive exploitation of lithium by the State	X		

Permanent liberalization of the Electricity Industry in International Treaties

Among the treaties signed by Mexico, the TPP[7] (now CPTPP[8]) is the only one that expressly includes, via the annex of reservations, the provisions related to the Energy Reform of 2013 (opening of the sector); both the USMCA (approved after the TPP) and all other treaties signed prior to it, benefit from this degree of openness by virtue of the most favored nation clauses contained in such agreements.

The USMCA, in its Article 32.11, provides the possibility for Mexico to adopt measures with respect to a sector or subsector, even if it has not included them in its reservations, as long as they are compatible with the more liberalizing measures it has granted in other agreements, which in the case of the electricity sector would be provided for in the CPTPP reservations.

Contrary to some arguments, although in Chapter 8 of the USMCA, Canada and the United States recognize -albeit unnecessarily- Mexico's ability to unilaterally amend its Constitution and secondary legislation, such power is not to the detriment of the rights and resources available to our partners in the same treaty. Both countries also recognize Mexico's direct dominion and inalienable and imprescriptible ownership of hydrocarbons, but without making an equivalent recognition with respect to the electricity sector.

All sovereign states have the capacity and the right to amend their Constitution and laws, but this power does not automatically exempt them from committing possible violations of the provisions of their trade agreements. In this

7: Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) signed by Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam. Annexes I and II included reservations concerning the energy sector regarding the planning and control of the system, as well as the public services of electricity transmission and distribution; however, Mexico did not reserve the generation of electricity. http://www.sice.oas.org/tpd/tpp/Final_Texts/Spanish/MEX_AnxI_s.pdf
8: Following the US exit from the TPP in 2017, the remaining 11 countries undertook negotiations to safeguard that treaty, resulting in the signing of CPTPP in 2018, which retains the general terms of the TPP, except for some refinements.

sense, does Mexico have the power to change its Constitution to impose tariff barriers to trade in any goods or services? Of course it does. Would this measure violate the USMCA? Evidently, and what is more, the treaty - as is common practice in these instruments - provides for remedies for affected parties and sanctions for offenders. Therefore, the introduction of such a clause is innocuous.

Moreover, both the TPP/CPTPP and the USMCA, as well as the European Union-Mexico Free Trade Agreement (EU-Mexico FTA) and various APPRIs (Agreement on Encouragement and Reciprocal Protection of Investments), consolidated the opening of the electricity sector through the *ratchet clause*.

Conclusions

The changes proposed in the reform to the LIE and the initiative to reform the Constitution violate the institutional framework that currently provides legal certainty to the parties involved in the generation, distribution and commercialization of electricity, by substantially increasing the control of the State in the sector at the expense of the interests of private investors and of the economic activity as a whole.

Furthermore, such reforms violate the rights established by Mexico in favor of foreign investors in various investment and free trade treaties -which under Mexican law are on par with the rights granted by the Mexican Constitution- to the extent that they evidently make access to the electricity market more restrictive and represent a setback to the guarantees granted by Mexico (CFE market share, abandonment of auctions, suspension of generation permits, licenses and contracts, alteration of dispatch, etc.).

This opens the door to trade reprisals and compensation payments, under solid arguments regarding National Treatment, Minimum Standard of Treatment and State-Owned Enterprises. It also weakens Mexico's ability to negotiate and defend its interests vis-à-vis its various trading partners in the future.

In the event of the violations of treaty commitments, investors have the right to go before international panels, which, due to the nature of the initiative, will have a high probability of resulting in awards that are unfavorable for Mexico and will result in the payment of considerable amounts in compensation. Likewise, our trading partners, when affected by these reforms[9], may request the establishment of dispute settlement panels, which would give them the right to impose trade reprisals.

The Mexican government can amend the rules of the game in the electricity sector at its discretion, however, these actions clearly violate the provisions of trade agreements. The costs will be high and not only in terms of expensive and polluting energy, compensation and reprisals, but also in the damage to both the reputation of the country as a reliable partner, as well as the mood of domestic and foreign investors.

Approving the constitutional reform to the electricity sector under the terms in which it was presented to Congress would imply jeopardizing one of the most effective instruments the country has to attract investment and promote growth, which is the USMCA.

9: Recently, US Trade Representative Katherine Tai estimated that there are $10 billion in US investments at risk from the reform.

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