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Energy Industry Group Newsletter

Mexico's President files a Constitutional Reform Bill on Energy Matters

On September 30th, 2021, Mexico's President filed before the lower house of the Mexican Congress the *"Bill that amends articles 25, 27 and 28 of the Political Constitution of the United Mexican States"* (the "Bill"). Pursuant to the content of such Bill, the legal and constitutional paradigm of the Energy Reform, which was enacted in 2013 and implemented in 2014, would be reversed, particularly on electricity matters. The Bill and its explanatory statements highlight the following:

• Regarding energy production and the power market:

a) It is proposed that the totality of the power value chain would be considered as a strategic area that would be only operated by the Mexican State.

b) Continuity of operations of current private generators, as long as such operations do not exceed 46% of the totality of domestic production, is proposed to be "acknowledged" (and probably for the infrastructure related thereto), subject to the planning and control of the national power grid through the Federal Electricity Commission (the "CFE") as the head of the electricity sector. It appears that this refers to installed capacity rather than to production, but this remains unclear.

c) Energy generated by private parties would exclusively be sold to the CFE through *"Long-term Bilateral Electricity Coverage Agreements"*, whose main terms and conditions, such as the validity term and price, are yet to be determined and would be probably subject to risks depending on the role played by the CFE and the financial instability that these type of limitations would impose on the market. The dispatch of private generators would be pursuant to production costs, defined in the Bill as the sum of variable and fixed costs, even though it remains unclear within the Bill if such production costs would be re-paid to private investors, or if the fixed costs would include debt return and depreciation or other important considerations.

This new regime would eliminate the qualified supply of energy, despite such elimination is not expressly mandated. Energy re-sale by final users to third parties would also be affected. Non-supplier traders would suffer the same fate due to the nonexistence of the market.

d) While the CFE would dispatch its power facilities at all times, the dispatch by private parties would be limited to the margin not covered by the CFE. Moreover, it is mandated that the National Center for Energy Control ("CENACE") would be reincorporated to the CFE and thus the CFE will be in charge of generation dispatch (let´s keep in mind that the CENACE would cease to be a legal entity and would return to being a CFE unit). This would eliminate any certainty regarding investments in effective energy generation, originating potential economic effects to developed projects under the Electricity Industry Law ("LIE", as per its acronym in Spanish) or existing legacy contracts.

It would be necessary to conduct a technical and economic study to assess the impacts that a dispatch system such as the one described above would have, which in addition to strengthening the CFE, would be based on payments calculated as a result of the sum of fixed costs plus variable costs. Any possible effect would impact consumers, except if such impacts are mitigated through subsidies, artificial amendments to production costs or in any other way, which remains unclear in the Bill but surely would not be economically sustainable in the long term.

e) Clean Energy Certificates ("CELs", as per its acronym in Spanish) would be eliminated and hence there would not be obligations for consumers regarding clean energy consumption, thus eliminating the most important mechanism in Mexico for the reduction of greenhouse gases emission at a domestic level (mechanism included within the nationally determined contribution in terms of the Paris Agreement, to be filed at the end of this month and at the beginning of November at the COP 26).

f) It is not addressed and remains unclear in the Bill what would happen to distributed generation systems or electricity projects operating: ***i)*** on island mode, ***ii)*** as isolated supply, or ***iii)*** as local generation, where there is a local consumption that is not wheeled through the national power grid, but rather a portion of surplus energy is pumped to the grid. Our concern focuses on the fact that local consumption is not entirely consistent with the idea that all the energy generated in Mexico may be acquired by the CFE. For such purposes, a prospective implementation regulation should: a) negotiate contracts with on-site power plants and establish a mechanism to access local measurement units, an alternative that may be feasible with larger on-site energy generation but not with distributed generation, b) intervene or expropriate power plants centers (with a less feasible result), c) allow on-site generation and sale of energy surplus to the CFE (the existent, not the new one), or d) implement a hybrid scheme between a) and c). Another important question would be what would happen to net metering, net billing and total sale schemes regarding distributed generation, since such have been seen as a burden for the CFE since the beginning (especially the former), given that the last two depend totally upon the electricity market.

g) Likewise, it is not clear what would happen to electricity importation and exportation legacy permits and to the holders of other authorizations pursuant to the LIE.

h) The Bill specifies the term "national security" with regard to the power sector. As we have seen in the recent legal reforms, such term is ambiguous and generates uncertainty with regard to the scope of its enforcement.

i) The proposed acknowledgement and acquisition in items b) and c) above would exclude: ***i)*** the self-supply scheme "*not granted pursuant to the Public Service Electricity Law"*, that is, such regime that includes holders with non-substantial equity in the project company, as well as ***ii)*** surplus generation capacity of independent power producers, due to it being presumed that the surplus generation capacity not sold to the CFE had been unlawfully implemented.

For the implementation of the above, all power generation permits and power purchase contracts granted are proposed to be cancelled, as well as various private generation schemes and requests pending resolution, eliminating, as a result, all projects in the pipeline. Moreover, the cancellation of contracts is proposed, including those entered into by private parties with the CFE.

j) Qualified users and self-supplied consumers would be directly managed by the CFE at the rates established by it, which do not necessarily meet market parameters. Currently, it is actually the Energy Regulatory Commission ("CRE" as per its Spanish acronym) who establishes the methodology for the calculation of rates for basic supply of consumers, so it remains unclear how such rates methodology would continue to be implemented as a result of CRE´s dissolution regarding qualified users. Currently such rates are negotiated between the parties, so it is foreseeable that these type of users would be affected regarding electricity costs.

k) Finally, electricity transmission and distribution fees would also remain at the discretion of the CFE, given CENACE´s proposed merger as a greater competition promoter and regulatory entity in the energy sector.

• Regarding governmental entities in the energy sector:

a) The strict legal separation regime of the CFE is eliminated and its nature is changed to a government entity, granting it autonomy regarding its activities and administration. Even though the extent of such autonomy remains unclear, we are certain that the Bill looks to integrate once again, vertically and horizontally, a monopoly. Likewise, some of CFE affiliates such as *CFEnergía, CFE Internacional, CFE Capital and CFE Telecomunicaciones e Internet para Todos*, will remain untouched, and new affiliates may be created. Notwithstanding the above, given the changes in the proper nature of the CFE, it is not clear what nature and which authorities its affiliates would have (surviving and new affiliates).

b) The CFE would become the state entity in charge of all activities in the power sector, including not only the electricity value chain, but the planning, control and dispatch of the grid. Therefore, the CENACE would be reincorporated with the CFE,

and private generators would again depend upon the CFE in that regard.

c) It is inferred from the Bill that the contracting schemes of the CFE in the foreseeable future would be limited to the traditional public procurement and acquisitions schemes, opening up space for public tenders and direct awarding procedures that have increased during the current federal government administration. This is consistent with the animosity of the current administration to Public-Private Partnerships.

d) On the other hand, the CRE and the National Hydrocarbons Commission ("CNH", per its acronym in Spanish) would be dissolved, transferring all regulatory and verification capabilities and powers to the Ministry of Energy ("SENER", per its acronym in Spanish), except for the planning of the power sector, which would remain at the hands of the CFE. The Bill sets forth that labor rights of employees working for the Federal Public Administration would not be impacted with these changes, not mentioning the impacts that employees in the private sector would suffer as a result of this possible reform, given the dramatic changes in market conditions that the implementation of this Bill would generate in our country.

e) Also noteworthy is the elimination of the term "productive company", which not only would it impact electricity matters but also the hydrocarbons sector, considering the role that *Petróleos Mexicanos* ("PEMEX", for its acronym in Spanish) has in such sector. Therefore, the Bill aims to eliminate references to CFE and PEMEX as state productive companies which originally looked for profitability and competitivity for the benefit of all Mexicans.

• Regarding Energy Transition Matters:

a) It is established that the CFE would act as the entity executing energy transition matters and necessary related activities, but it remains unclear how SENER or the State would enact energy transition policies. Noteworthy is the fact that energy transition is widely related to the hydrocarbons sector, which remains outside the scope of the CFE and it is not cleared within the content of the Bill. What is obvious is that if the Bill is implemented, Mexico would be further delayed regarding its compliance with domestic and foreign commitments on greenhouse gases reduction, a goal that will surely be pushed to the back burner, as recently demonstrated by the federal administration.

b) A "priority area for the development of the required industries for energy transition" is established, which includes: science and intellectual property of the state of technology and critical equipment; the domestic technological development, manufacturing of capital goods, raw material and equipment for final energy consumption, electromobility, water-energy systems for food self-sufficiency, lightning, and strategic mineral transformation, industry, commerce, services, distributed generation, power storage, and more. These type of targets evidence the federal government´s appetite to dabble in new areas where it lacks necessary experience, knowledge and financing to succeed in a cost-effective way.

Also noteworthy is the fact that energy transition is present in any and all activities in Mexico, so the wording of the Bill creates an important legal gray area that may restrict private participation in this matter, since the CFE would be "in charge" of all these activities, which generates uncertainty towards investors.

c) Likewise, it is mentioned that a national financing scheme would be used as an impulse for Mexico´s development, which is scarce and more expensive if compared to interest rates of international organizations. In addition, it appears that the Bill excludes international financing as a source of funds for these type of projects, which is key for the mitigation of climate change, since such funding represents the financial aid of more developed countries to mitigate this major global problem.

• Regarding lithium and strategic minerals:

The Bill proposes that lithium and other strategic minerals could not be put under concessions and should be exclusively exploited by the State. That is, it proposes to establish a new State monopoly with likely disastrous results, as we have seen in the past. In respect thereof, it is set forth that valid mining concessions for lithium exploitation would not be affected, conditioned by due endorsement by the Ministry of the Economy, the non-retroactivity principle provided for by the Federal Constitution a long ago.

• Changes to secondary regulations:

It is clear that the due execution of the Bill, in the event it is approved by the Federal Congress, requires the amendment of the legal and regulatory framework on the matter, and therefore it proposes a term of 180 days for the Congress to make the necessary adjustments to the legal framework.

In principle, we remark that the approval of this Bill will not follow an easy route. The legislative process to amend the Federal Constitution requires the approval of the Bill by a qualified majority of two thirds of those present in the Chamber of Deputies and in the Senate. This means that, for its approval, it requires at least 333 votes from the Federal Deputies and 85 votes from the Senate. Likewise, in the event that the required votes are secured in the Congress, the Bill would require to be approved by the majority of the state congress in order to be fully approved.

Note that a constitutional reform such as the one included in the Bill will generate violations to various laws on anti-trust, environmental and climate change matters, human rights, and various International Treaties to which Mexico is a party, regarding international investment protection, environmental protection, and more.

For administrative and constitutional litigation purposes, in principle, a constitutional reform such as the one proposed in the Bill would not be challengeable by private parties through any legal mean of defense, not even through an Amparo trial (due to an express constraint contained in article 61 of the Amparo Law). Notwithstanding the above, our team specialized in Constitutional and administrative litigation on energy matters has designed a route so that, in the event that the Bill is approved and becomes valid, the companies and organizations of the civil society can pursue legal means of defense in a national venue against its content.

Our legal assistance focuses on the relevant analysis and filing of domestic and international legal defenses. We are at your service to assist you in connection with the legal alternatives that may best protect your commercial interests.

This content was prepared by Guillermo Villaseñor-Tadeo (gvillasenor@sanchezdevanny.com), Alfonso López-Lajud (alopez@sanchezdevanny.com), José Antonio-Postigo Uribe (japostigo@sanchezdevanny.com), Gerardo Prado-Hernández (gph@sanchezdevanny.com), Verónica Esquivel-Patiño (vesquivel@sanchezdevanny.com), Mauricio A. León-Alvarado (mleon@sanchezdevanny.com), Tania Elizabeth Trejo-Galvez (tetrejo@sanchezdevanny.com), José Antonio Tellez-Martínez (jatellez@sanchezdevanny.com), Biuludani Altamirano-Magaña (biuludani.altamirano@sanchezdevanny.com), and Paulina Doen-Castillo (paulina.doen@sanchezdevanny.com).

Contact

Alberto Campos-Vargas
jacampos@sanchezdevanny.com

Alfonso López-Lajud
alopez@sanchezdevanny.com

Gerardo Prado-Hernández
gph@sanchezdevanny.com

Guillermo Villaseñor-Tadeo
gvillasenor@sanchezdevanny.com

José Antonio Postigo-Uribe
japostigo@sanchezdevanny.com