

## **CLIENT ALERT**

### **The Mexican Energy Ministry Reasserts its Authority in the Electricity Sector**

**May 20, 2020**



#### **Executive Summary**

On May 15, using the COVID-19 health emergency as justification, the Ministry of Energy (SENER) issued a decree that will dramatically impact the renewable electricity sector in Mexico while threatening at least \$6.5 billion in investments in renewable energy projects. The decision is the most brazen yet from the administration of Andrés Manuel López Obrador (AMLO) on its march to gain control over the oil & gas and electricity sectors in the name of energy independence. The changes effectively vest with the Mexican government the power to cut off the sale of privately generated renewable power in favor of generation from the state-owned utility, CFE, though the decree allows the Energy Ministry to declare certain projects as strategic to achieving the objectives of AMLO's energy policy, thus keeping them viable. With USMCA not coming into effect until July 1, investor's seeking protection from the decree can turn to NAFTA's expansive investor protection provisions to protect their interests in affected power generators, although a more immediate course of action may be to challenge the decree in the domestic courts through an *amparo*.

#### **SENER Takes Control Over Electricity Dispatch**

Declaring a need to ensure the supply of electricity during a pandemic, SENER issued a decree giving it full control over the National Electricity System that went into effect on May 16. It is the latest and most expansive step in the López Obrador administration's attempt to establish Mexican energy independence in both oil & gas and electricity. Specifically, the decree changed the regulation governing electricity supply to require that



power be sourced with the “strategic” interests of Mexico in mind. Importantly, it gives SENER and the state-owned electric utility, the Federal Electricity Commission (CFE), the role of deciding what is “strategic” and thus full discretion over the source of electricity supply in Mexico.

### **Why is This Happening Now?**

AMLO’s goal for energy independence includes for Pemex, the state-owned oil company, to produce, refine, and sell products to meet all of Mexico’s needs, and his administration’s policies have spent the last year and a half pushing this agenda. A byproduct, however, of refining more of Mexico’s heavy oil is an increase in the production of low-value, residual fuel oil. At the same time, demand for this heavily polluting product has declined sharply due to regulations prohibiting the use of fuel oil for shipping that went into force at the beginning of this year. This combination – supply up, demand down – has created a major problem for Pemex, which has limited storage capacity. Prevented from selling to the maritime market and unable to find enough storage, the firm’s best option is to burn fuel oil for electricity generation.

Burning more fuel oil, however, faces one major challenge – a regulation from the 2013 energy reform that requires CFE to dispatch the cheapest source of electricity available, which in Mexico is increasingly derived from renewables. And renewables are provided almost exclusively by the private sector, which committed billions of dollars to the Mexican market after it opened through the Energy Reform.

What do you do if your goal is to consolidate state control over the electricity sector, but regulations favor private supply? You declare it in the national interest to change regulations and grant the authority to determine what is “strategic” to allies who share your view. Manuel Bartlett, CEO of CFE, has long argued that the purported intermittent quality of solar and wind energy makes them unreliable sources of electricity generation, which became the formal justification from their exclusion from CFE purchases under the “strategic” provision of the new decree.



## Impact is Clearly Negative for Renewables...

The clear implication of this policy change will be to interrupt investment in renewable energy projects and undermine renewable generators' capacity to sell power. While it will still be possible to work with the Ministry of Energy to classify a particular project as essential or strategic, there can be little doubt that this policy change is poised to have a powerfully negative impact on renewable power generators in Mexico. According to the ASOLMEX (solar) and AMDEE (wind) trade organizations, 44 existing renewable projects in 18 states worth \$6.5 billion and accounting for 29,500 jobs will be impacted by the decree, not including projects in the early development stages that have not broken ground, which could add another \$3-5 billion per year of investment during the remainder of AMLO's term. In addition, the decree will make it much more difficult and expensive for new renewable projects to obtain government authorization, further dampening the investment climate for renewable energy in Mexico.

## ...But There Are Options to Respond

Investors affected by this order may resort to domestic courts to challenge it, seeking to obtain an injunction (known as an *amparo*), [which has been granted to at least three firms to pause an April 29 order from Mexico's power market operator, CENACE](#), that was also designed to curb the expansion of renewables. At the same time, NAFTA offers an alternative mechanism through which Canadian and U.S. firms can protect their interests in the face of the May 15 decree. The only caveat is that once an investor chooses to pursue an international arbitration procedure, it must withdraw all domestic legal actions.

Since the decree was promulgated prior to July 1, NAFTA still governs U.S.-Mexico investment relations related to this matter. It is thus the international mechanism through which renewable power generators can protect their interests from the implications of the May 15 decree. NAFTA provides investors with protection not only against formal expropriation, but also actions "tantamount to expropriation" as well as a guarantee for "fair and equitable treatment" and "full protection and security" for their investments. It also gives foreign investors the right to bypass local courts and directly submit a claim via NAFTA's international arbitration mechanism.



There may be some recourse as well under the USMCA. However, at the insistence of the Trump administration, the new USMCA has many fewer protections for investors than did NAFTA. The theory was that investor protections encouraged U.S. companies to invest in Mexico rather than the United States by absorbing much of the risk associated with investing in Mexico. Still, the USMCA preserves an Investor-State Dispute Resolution mechanism between the United States and Mexico for the energy sector (among others). And it grandfathers what it calls “legacy investments” by allowing investors in Mexico prior to USMCA coming into effect to submit a claim under the NAFTA dispute resolution mechanism for up to three years after the July 1, 2020, start date of the USMCA.

The private sector and many foreign governments have already lodged formal complaints about the new law. Canada and the European Union immediately dispatched diplomatic letters that sharply criticized the May 15 decree. The EU expressed “profound concern” about the measure and asked for a meeting with the Mexican Energy Minister, Rocío Nahle, to discuss the matter while the Canadian Embassy in Mexico noted the negative impact the decision would have on investment and job creation in the sector. The United States Ambassador, Christopher Landau, [has made public statements challenging Mexico’s frequent changing of the rules of the road in the energy sector](#). While the U.S. government is currently evaluating its formal response, we expect it to follow the lead of other nations in objecting to the policy. No doubt, the last word has not been spoken on Mexico’s electricity regulations, and Monarch will keep a close eye on developments and provide updates as necessary.