Monarch News

November 16, 2021

CEO's Executive Summary

In this newsletter, we dig into two legislative/regulatory issues in Mexico that could have a profound impact on U.S. companies operating there. First, we look at President Andrés Manuel López Obrador's (AMLO) proposed legislation that would upend the electricity sector in Mexico and effectively cancel the historic 2013 reform that opened the sector to competition. Much has already been written about the policy details of the bill currently working its way through Congress, but we focus on the president's strategy to get the constitutional reform approved, the political benefits he hopes to accrue regardless of the bill's fate, and the very weak U.S. response so far to a measure that will have negative implications for U.S. firms operating in the electricity sector and on North American integration more broadly. The proposed changes are controversial within Mexico, and Monarch does not think approval as currently written is the most likely outcome, but it cannot be ruled out. Consequently, we believe that a much more aggressive U.S. effort to defend the interests of U.S. companies lawfully operating in Mexico is in order.

Second, we discuss a less well-known development in Mexico that could have significant impact on all firms operating in the country – new requirements from the Mexican tax authority requiring a detailed, **digital bill of lading** designed to fight the trade in illegal and counterfeit goods. These changes are **scheduled to go into effect on December 1** despite the short lead time, the onerous burden of the requirements, and the fact that the requirements have not yet been codified in any legally enforceable document.

Proposed Electricity Counter-Reform

On September 30, Mexican President López Obrador introduced legislation to reverse the historic 2013 liberalization of the electricity sector and make other changes that would effectively take the sector back 30 years to when the state electricity company, *Comisión Federal de Electricidad* (CFE), faced no competition. By now the contents of the reform are well-known. In summary, the legislation would eliminate the open market created by the 2013 reform, and CFE would no longer be a semi-independent firm subject to market competition but would instead revert to being a fully state-owned enterprise operating as the sole supplier of electricity in the country. The proposed legislation guarantees that the CFE will generate 54% of the country's electricity, with the private sector allowed to generate the remaining 46% but subject to CFE's complete planning and control of the national electricity system. All private power contracts would be eliminated and replaced with new CFE purchase contracts, and Clean Energy Certificates, created by the 2013 reform, would also cease to exist. Predictably, the business community views the legislation as a wholesale assault on private generators and potentially the death-knell for renewable energy investment in Mexico.

While the legislation's supporters had initially hoped to fast-track it through Congress, the bill has been delayed and now looks likely to be voted on in Spring 2022. The initial delay was attributed to the need to approve the 2022 budget first. With the budget process now complete, hearings are expected to begin in the Chamber of Deputies in late November where representatives of private electricity generation firms should be invited to testify. The Senate would then take up the measure after it is voted on in the Chamber. Legislative leaders from AMLO's Morena party had initially promised to have the measure approved before the end of this year. But on November 3, the party leader in the Chamber announced an extension of this deadline to April 15 because, simply put, they do not currently have the votes to pass it.

As a constitutional reform, the legislation needs to be approved by 2/3 of the members of both houses of the federal legislature, and by a majority vote in a majority of Mexico's 32 states. Morena and its allies control a majority of Mexico's statehouses, and they control a simple majority in the federal Congress, but they do not control the needed qualified majority in either the Chamber of Deputies or the Senate. Since most opposition parties are refusing to even discuss what would be a complete reversal of the 2013 Energy Reform, Morena's only hope for success lies with the Institutional Revolutionary Party (PRI), the party that governed Mexico uninterrupted for 71 years until 2000 but is now fighting for its political survival. The PRI controls enough seats in both houses to assure approval if AMLO can win them over, and PRI party president, Alejandro (Alito) Moreno, initially indicated that his party was willing to discuss the reform.

Though initially refusing to consider any changes to the legislation, President López Obrador stated in early November that he would accept some negotiated modifications to the bill. He insisted, however, that these cannot change the "essence" of the reform, which he defines as the state retaining full control of the electricity sector and eliminating the profit motive from the sector. Meanwhile, Alito Moreno conditioned PRI approval on three measures: that it will benefit the economy and the country, that is has popular support, and that it benefits from a robust debate in the government. Within these parameters, a recent *El Financiero* poll showing 51% popular approval for the reform and an *El Universal* poll showing seven in ten Mexicans think the PRI should back the reform would argue for the PRI's support, and Morena politicians have called on the party base to organize protests in support of the initiative. Yet the PRI is also home to many legislators who are on the record having voted for the 2013 reform, and many of those are dead set against reversing it. (There currently appears to be enough PRI opposition in the Senate to block the reform.) Moreover, AMLO's refusal to make any concessions on the federal budget that was recently approved has led PRI leaders to resolve to block the energy bill, casting serious doubt on its future.

In this context, it is hard to see how Morena can capture the 56 PRI votes needed in the lower house and the 14 needed in the Senate (after the September defection of one Morena and two Labor Party Senators) without making some meaningful changes to the legislation, despite AMLO's current opposition. This combined with the extended time frame for approval opens the door to the possibility of minor, but potentially significant, changes to the legislation.

Morena's refusal to accept any changes to AMLO's budget proposal suggests the president will rely heavily on coercion to pass the electricity reform.

AMLO's Ulterior Motives?

In addition to returning CFE to its once dominant position, AMLO appears to have a parallel political objective with the electricity reform – to split the PRI in advance of both the June 2022 gubernatorial elections and the 2024 presidential election. While the president of the PRI has insisted that his party will vote as a block on the electricity reform, given the number of PRI legislators who have already stated their firm opposition to the measure, it is hard to see how he keeps to this promise without splitting the party. And since the PAN has said a PRI vote for the measure would lead to their expulsion from the opposition alliance, it is also hard to see the PRI selecting this option. Alito Moreno, the former governor of Campeche who now leads the PRI, is thus left with three bad options: splitting his party by insisting that the PRI vote against a proposal with public support, splitting his party and the opposition alliance by insisting that the PRI vote for the measure, or allowing party members to freely vote their conscience without any repercussions thereby weaking party unity and his role as party leader. For AMLO, while some outcomes are better than others, there is not a truly bad result as it relates to weakening his political opposition.

Surprisingly Anemic U.S. Response to the Reform

Given the stakes at play, the United States government's response to AMLO's proposed counter-reform have been, in short, shockingly weak. The first public comment on the electricity reform from a USG official was a November 3 tweet by Ambassador Ken Salazar. The muted strategy appears to be driven by two things: first, a desire to lock in Mexico's continued cooperation on the migration front by avoiding anything that might jeopardize this goal; and second, an effort to build a personal relationship of trust between AMLO and Ambassador Salazar before making any big asks of Mexico. As a result, the United States is still tip-toeing around AMLO, despite President Biden now having been in office almost a full year.

Mexican pundits have suggested that Morena's decision to postpone the electricity reform vote was due to pressure applied by the United States during the meeting between

Ambassador Salazar and Mexican government officials, but it does not appear that any serious effort was made to turn up the heat on Mexico. While the ambassador noted in his tweet that he expressed "serious concerns" about the reform, he does not appear to have made a specific ask of the Mexican government. AMLO, the only person with the power to postpone the electricity vote, was not even at the meeting. In addition, Mexican Energy Secretary Rocío Nahle, a participant in the meeting, characterized it in a tweet as opening the door to continued dialogue and collaboration. Such a positive read out would be unlikely if there had been a truly strong U.S. expression of dissatisfaction with the proposed reform. Finally, AMLO insisted a few days later that the U.S. government has not formally protested the energy reform, and Foreign Minister Marcelo Ebrard took pains to clarify that the delay was not requested by Ambassador Salazar or the U.S. government.

This cautious U.S. approach to AMLO seems insufficient given the task at hand. Our relationship with Mexico is much broader than migration, encompassing North American integration, security, and climate change among other matters. The management of this complex, deeply interdependent relationship requires that Washington become directly involved. It is good news that Presidents Biden and López Obrador will meet face-to-face in a bilateral discussion while attending the North American Leaders Summit on November 18, but this kind of high-level engagement needs to become much more regular. The proposed electricity reform, meanwhile, has huge implications for the North American project beyond simply violating the USMCA.

First, it directly damages the interests of cutting-edge U.S. renewable energy firms, as U.S. leaders of these firms made clear in a meeting with Ambassador Salazar on November 3. The Mexican government seems determined to undermine foreign investment in renewables, through a range of non-tariff barriers like denying perfunctory permits to renewable projects, even when they are legally entitled to them and when projects are all but complete and ready to energize, all the while granting expedited attention to the needs of CFE's own projects. This hostility is ironic given that renewable energy generates electricity in Mexico at nearly a third the cost of CFE's historical costs and supporters of the counter-reform argue that one of its main goals is to decrease the cost of electricity. In addition, AMLO argues for his policies on the basis of restoring Mexican national sovereignty in the energy sector, yet his administration completely disregards that Mexico is blessed with wind and solar "sovereign" endowments, as though only hydrocarbons under the ground merit the nation's attention and support.

Second, the energy reform will clearly weaken North American competitiveness and regional collaboration with respect to supply chain resilience, precisely at the moment when Mexico should be aligning itself with North America in the competition against an ascendant China. American firms will be disadvantaged in several respects, including by a higher cost of electricity that is a critical factor for manufacturing competitiveness, and because they face increasing shareholder and regulatory pressure to reduce their carbon footprint throughout their value and supply chains. This will become increasingly difficult to achieve in a Mexico that depends for its electricity on the burning of coal, dirty fuel oil, and even imported natural gas.

Finally, the proposed reforms run completely counter to the United States' interest in reducing carbon emissions consistent with the Paris Agreement and the new pledges made at the COP-26.

Mexico has gone from a promising leader to a clear laggard globally in the fight against climate change. AMLO's decision to double-down on petroleum production, refining, and the use of carbon-based fuels in electricity generation is simply not compensated by his promised climate change actions. At their mid-October Palenque meeting, AMLO promised U.S. Special Envoy for Climate Change John Kerry that Mexico would make its carbon reduction proposal under the Paris Agreement more ambitious by early next year and would work closely with the U.S. to accelerate its use of renewable energy. In a November 4 letter to President Biden, AMLO also promised to no longer export oil (using it instead for internal consumption), to modernize 14 hydroelectric plants, to reinforce his *Sembrando Vida* reforestation program, to reduce Mexican methane emissions as required by the COP26 agreement that Mexico signed, and to refuse further government concessions for the mining of "toxic minerals" in Mexico. **While AMLO clearly does not want to be seen as opposing the fight against climate change, his actions contradict his public rhetoric.**

We want to be clear that we do not believe AMLO is a climate "denier," and we believe *he believes* his actions are designed to strengthen Mexico and its institutions, namely CFE and Pemex. But we also believe his policies are gravely mistaken and will achieve the opposite of what he intends while inflicting substantial damage on the Mexican economy, and by extension, the competitiveness of North America as a whole at the worst possible moment. We hope the United States will follow Ambassador Salazar's lead and begin to speak out more vigorously about its concerns on this front, beginning at the NALS summit this week in Washington. It would be a mistake to assume that AMLO cannot get the votes he needs to pass the reform. The time for more vigorous engagement is now.

Important Development: New Digital Bill of Lading Requirements

On June 14, 2021, Mexico's tax authority, *Servicio de Administración Tributaria* (SAT), published an Administrative Tax Rules proposal (known as *Resolución Miscelánea Fiscal*), by which any company transporting goods within Mexico would be obligated to attach a digital bill of lading (CCP) to the corresponding electronic invoice (CFDI).

According to Raquel Buenrostro, head of SAT, this measure is designed to prevent trade in illegal and counterfeit goods (initially, it focused on the illegal trade in gasoline and derivatives but now covers all industries) by allowing authorities to use information declared through online accounting, electronic invoicing, and now, a digital bill of lading to verify the goods being transported.

This mechanism assumes that critical information about the trade in question is known prior to issuing the digital bill of lading and is declared as an Annex to a CFDI (this form includes approximately 180 fields of mandatory, conditional, and optional data) that must be digitally stamped and immediately registered with the tax authorities. Examples of this critical information include the value of the goods, the price of the carrier services, and the routes through which the goods will be carried, among others.

Due to the complexity of these measures, SAT and the *Secretaría de Comunicaciones y Transportes* (SCT) agreed to establish work committees with the private sector based on different types of transportation modalities affected by the rule (rail, sea, air, land, courier, valuables, and business associations).

As a result of the progress of the work committees, the authorities announced an extension of the effective date of these measures until December 1, 2021. Nonetheless, noncompliance with these measures will not be sanctionable until January 1, 2022.

Implications for non-compliance range between administrative fines, non-deductibility of the purchase of goods or carrier services, and ultimately the seizure of goods.

One of the main challenges for companies and carriers will be to issue/obtain detailed information for each shipment to prevent delays and fines. Completing the CCP will be a joint responsibility of the transportation service provider and the engaging company, supported by SAT-administered technological platforms to facilitate the supply and exchange of information.

In recent weeks, SAT has released important criteria related to the application of these obligations on companies on their website's frequently-asked-questions section. It has also included on its website instructions for filling out the CCP and the technological standard that web developers must consider when incorporating the CCP annex to their CFDI platform. Last week, SAT also issued a sixth proposal for administrative tax rules that further details these obligations. No legally enforceable document, however, currently establishes these important changes.

Due to the lack of legal certainty, and the time and cost involved in implementing these changes by companies and carriers to their CFDI platforms (assuming they have one, as many carriers are not currently issuing electronic invoices), many business associations have voiced their discontent with these measures and the short timeframe provided to comply with them. Monarch has been tracking this policy closely and assisting clients with their compliance efforts; our Monterrey-based team is available to help other companies in need of assistance.

* * * *

Monarch News© is a publication of Monarch Global Strategies LLC (all rights reserved) that is provided to our clients and friends of the firm as a courtesy. The Editorial Team includes Dr. Pamela Starr, Geoffrey Jones, and Michael Camuñez with support from the entire Monarch team.

Michael C. Camuñez
President & CEO
mcamunez@monarch-global.com
Los Angeles

James R. Jones
Chairman
jjones@monarch-global.com
Washington, D.C.

Luis Ricardo Rodríguez
Managing Partner
lrodriguez@monarch-global.com
Monterrey

Geoffrey G. Jones
CFO & SVP Development
gjones@monarch-global.com
Washington, D.C.

Pamela K. Starr
Senior Advisor
pstarr@monarch-global.com
Los Angeles

Pedro Niembro
Senior Director
pniembro@monarch-global.com
Mexico City

Juan Casillas
Senior Advisor
jcasillas@monarch-global.com
Mexico City

Gabriel Cavazos
Senior Advisor
gcavazos@monarch-global.com
Mexico City / Monterrey

Begoña Sánchez
Director
bsanchez@monarch-global.com
Monterrey

Patricio M. Martínez
Associate
pmartinez@monarch-global.com
Monterrey

Jessica Blystone
Operations Manager
jblystone@monarch-global.com
Washington, D.C.