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Initiative to Reform the Mexican Constitution on Energy Matters

On September 30, 2021, the President of Mexico submitted to the House of Representatives (*Cámara de Diputados*) an initiative to reform Articles 25, 27 and 28 of the Federal Constitution of Mexico (the “Initiative”). The Initiative seeks to reorganize the Mexican electricity industry in Mexico and allow for greater state control in such industry by limiting participation of private investors.

Constitutional Reform Process

Since this is an initiative to reform the Constitution, the approval by a supermajority in both houses of Congress and a majority of the state legislatures of Mexico are required for the Initiative to pass. On that note, for the Initiative to be approved, the following majorities are required:

- (i) Favorable vote of two thirds of the members of the House of Representatives (*Cámara de Diputados*), that is, 333 out of 500 representatives. Currently, Morena¹ and its coalition political parties have 277 representatives, therefore, assuming that all of such representatives grant their approval, an additional 56 favorable votes granted by representatives of opposition parties would be required for the Initiative to pass;
- (ii) Favorable vote of two thirds of the Senate (*Cámara de Senadores*), that is, 85 out of 128 senators. Currently, Morena and its coalition political parties have 78 senators, therefore, assuming that all of such senators grant their approval, an additional 7 favorable votes granted by senators of opposition parties would be required for the Initiative to pass; and
- (iii) Once approved by both houses of Congress, the favorable vote of the majority of the state legislatures of Mexico would be required, which means that 17 out of the 32 state legislatures would need to approve the Initiative by a majority vote of their members. Currently Morena and its coalition political parties have the majority in 21 of the state legislatures of Mexico, therefore, assuming that the majorities described in (i) and (ii) above are reached and provided that the majority of the members in the state legislatures controlled by Morena grant their approval, the Initiative would pass.

¹ Morena is the party to which the President of Mexico belongs and which has a majority in the Congress.

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Main effects of the Initiative on the Mexican Electricity Industry

The Initiative seeks to make the following amendments to the Mexican Constitution, which would have significant effects on the Mexican electricity industry and the participation of private investors in such industry:

- (i) **Electricity as a strategic activity.** The Initiative seeks to include the electricity industry, which comprises the transmission, transformation, distribution and supply of electric power in Mexico as a strategic activity that would be reserved exclusively to the Mexican State. This would result in a change of policy with respect to the current situation, which allows for participation by private parties in diverse sectors of the electricity industry and reserves only some of the sectors within the industry, such as transmission and planning of the electric system to exclusive State control.
- (ii) **Federal Electricity Commission.** As stated by the Initiative, the Mexican State would conduct its activities in the strategic activities of the electricity industry through the Federal Electricity Commission ("CFE"). On that note, the Initiative seeks to transform the CFE into an autonomous State owned entity that would be responsible for (1) the control and planning of the national electricity system, (2) the determination of the tariffs applicable to the transmission and distribution grids, and (3) the definition regarding the participation of private investors in the generation of electric power. Within the scope of its authority, CFE would undertake the measures necessary to implement the Initiative and assume control of the Energy Transition as it relates to electric power.

If the Initiative is approved, CFE would again be consolidated into a single entity, similar to that existing prior to the 2013 constitutional reform that will assume the functions that had been assigned to subsidiaries of CFE and other entities created by the 2013 reform. As a result, the subsidiaries of CFE that are currently responsible for basic supply, generation and transmission, as well as the National Energy Control Center ("CENACE"), would be consolidated within a single entity. Such single entity would continue to operate the electricity market, provide access to the transmission and distribution grids, as well as the generation, basic supply and dispatch of electric power.

It should be noted that pursuant to the provisions currently in force, CENACE is responsible to act as an independent operator of the Mexican electricity system. Its reincorporation into CFE could result in inequitable and uncompetitive treatment of the other participants of the Mexican electricity market.

- (iii) **Suppression of Autonomous Regulatory Bodies.** The Initiative proposes to suppress the Energy Regulatory Commission and the National Hydrocarbons Commission. Upon entry into force of the Initiative, the authorities and functions of those autonomous bodies would be absorbed by the Ministry of Energy. This change may negatively affect decisions regarding energy policy previously taken by individuals having the technical expertise and operation autonomy necessary to regulate the energy market in a transparent manner.

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- (iv) **Generation.** The Initiative seeks to reserve 54% of the electric power generated in Mexico exclusively for CFE. However, the Initiative is not clear as to whether such percentage will be measured on an annual, monthly or hourly basis. The Initiative also allows the participation of the private sector in the generation of up to 46% of the electricity required by the country, but it is also not clear how such percentage will be measured.

If the Initiative is approved, the energy and capacity generated by the private sector may be solely acquired by CFE (1) on the basis of the lowest short term production costs, and (2) through long term power purchase agreements to be entered into with private parties, without the need for CFE to subject the execution of such contracts to public bidding or tender processes. All private sector power plants would have to comply with such rules, regardless of the date on which they were built or started commercial operation, and without considering the grandfathered regimes that currently exist in Mexico.

If the initiative is approved, CFE would have the authority to establish the terms of the agreements for the acquisition of energy and capacity, as well as for the contracting of goods, services, works and fuels.

- (v) **Supply and Dispatch.** If the Initiative is approved, the electricity supply public service would be provided exclusively by CFE, which will be able to acquire electric power from private parties subject to the execution of the agreements described above and in any case subject to the 46% generation limit described above.

As indicated above, considering the functions of CENACE are proposed to be taken over by CFE, the dispatch procedures of the power plants connected to the national grid would be controlled by CFE, who would carry out such dispatch on the basis of economic merit. The Initiative lacks details on the concept of “economic merit”.

- (vi) **Permits and Agreements.** If the Initiative is approved, upon entry into force of the reform, all power generation permits and power purchase agreements with the private sector, without exception, would be cancelled or terminated. The cancellation of power generation permits would likely result in all private power plants having to suspend generation until the regulatory laws are issued (180 days term) or the rules for the purchase of energy by CFE from certain generators are implemented, whichever occurs first. Such entry into force would also result in the cancellation of any pending amendment requests filed before any of the regulatory bodies that the Initiative seeks to suppress.

- (vii) **Self-supply.** The Initiative establishes that only the “authentic” self-supply power plants that have complied with the provisions of the now repealed Public Electricity Service Law may participate in the percentage of generation permitted to the private sector. However, the Initiative is not clear in defining, among others, (1) which self-supply plants should be considered as “legitimate” or “authentic” and (2) which steps self-supply companies should follow in order to continue operating, considering the cancellation of their generation permits.

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- (viii) **Clean Energy Certificates.** If the Initiative is approved, the Clean Energy Certificates would cease to exist. Therefore, generators selling such product in the electricity market would no longer be able to do so and, presumably, the obligation of carbon emitters to purchase such certificates would cease to be enforceable.

This cancellation would likely result in CFE becoming the only entity in charge of complying with Mexico's international commitments regarding the reduction of atmospheric emissions, and following up on the various legal provisions regarding energy transition that are currently in effect in Mexico. Considering the high reliance of CFE on generation sources with high carbon emissions, it seems unlikely that Mexico will be able to meet its international commitments under this new regime.

Other effects of the Initiative

- (i) **Lithium and other mineral reserves.** The Initiative establishes that no concessions will be granted for the exploitation of lithium and other minerals considered “strategic” for the Energy Transition. Details on those “other minerals” are not provided in the Initiative. The mining concessions currently in effect and those in respect of which the Ministry of Economy has confirmed the existence of lithium exploration, shall continue in effect and would not be cancelled upon the enactment of the Initiative.
- (ii) **Hydrocarbons.** The Initiative proposes to include the possibility for the State to carry out exploration and extraction activities of oil and other hydrocarbons through concessions to State Entities and not only to Petróleos Mexicanos.

Comments on Potential Defensive Strategies

Since the Initiative is pending approval, the commencement of defensive strategies would likely be inadmissible until the Initiative is approved and enters into force.

In the event that the Initiative is approved, it will be necessary to analyze the possible defense mechanisms, including under the various investment protection treaties to which Mexico is a party. In this regard, it will be necessary to review the situation applicable to each project or investor as well as the protections, if any, available to each party involved under the treaty that may apply to each investment or project.

We invite you to reach out to your usual contacts in the Energy and Projects Practice at Ritch Mueller to discuss any particular situation regarding the Initiative, its specific consequences and potential defensive strategies in relation to any such consequences. Alternatively you may contact us at contacto@ritch.com.mx so that we may direct your concerns to the appropriate members of our team.