Mexican state takes drastic action against renewables projects

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On 15 May 2020, the Mexican state took a series of extraordinary measures against renewables projects. In this article, we place those measures in context; explain what their impact would be if they take effect unchallenged; and look at ways that they could be challenged as unjustified. Whilst any analysis of the issues involved is, at this stage, necessarily only very preliminary, investors in Mexican renewables projects would be well advised to consider their legal options as a matter of urgency.

Background

For more than 15 years, Mexico's energy policy and regulatory actions were clearly aligned with the promotion of private investment in the electricity sector, particularly generation from renewable energy sources. In 2013, the Mexican electricity industry was completely transformed with the creation of a new wholesale electricity regime, the establishment of an independent system operator and a key role being given to the development and use of renewable energy. Between 2013 and 2019, the amount of solar and wind power in the country roughly quadrupled.

Although the current generation mix is more than 80% fossil fuel and hydro, wind and solar account for some 40% of planned new capacity. International utilities and renewable investors have played a major part in this growing Mexican renewable pipeline. Billions have been invested in renewable energy projects and prices offered by private developers to the *Comisión Federal de Electricidad* (CFE), the national utility company, have been among the lowest worldwide. But the fairy tale may have come to an end in the administration of left wing President Andres Manuel Lopez Obrador.

With the concept of *energy sovereignty* in the centre of its political discourse, the current administration has factually reversed many of the changes introduced in 2013 energy reform, through several actions clearly intended to limit private investment in the energy sector and resume full control through the state-owned companies, Pemex and CFE. In this context, renewables (where private investment predominates) are now being challenged by a new policy issued by Mexico's Ministry of Energy, which substantially restricts solar and wind power projects from accessing the national grid, while favouring CFE's more expensive, fossil-fuel-fired generation.

In one sense Mexico exemplifies wider trends. Many jurisdictions have seen the rapid growth of renewables over the last 10 or so years, often encouraged by a range of fiscal advantages, direct financial incentives or regulatory adjustments in their favour. Often the path of growth has not been smooth. In Europe, for example, Italy, Poland, Spain and the UK have all seen governments or regulators taking action to remove or reduce incentives for renewable projects dramatically at various points – sometimes purely because of worries about the costs that subsidies impose on public finances or consumers, sometimes for what appear to be more political than economic reasons. The Mexican government's change of direction seems to be at the more extreme end of the spectrum of renewables policy revisionism, in terms of both its motivation and impacts.

Shock tactics from the state compel industry to take whatever steps it can, either in national courts or through dispute

resolution procedures in international investment treaties, to force governments and regulators to think again, or to seek compensation for losses unjustly incurred. Although the applicable rules vary from one jurisdiction and forum to another, the broad outlines of these struggles tend to be the same. On the one hand, courts and arbitral tribunals recognize that states have a right to take certain decisions about their energy sectors, and that they sometimes have to act quickly in doing so. On the other hand, particularly when interfering with what amount to the accrued rights or legitimate expectations of investors, governments and regulators must also act fairly (for example, respecting norms of due process and principles of proportionality), and avoiding undue discrimination.

The consequences of the latest action by Mexico are potentially so serious that it seems very likely that investors will take legal action in response to it.

The Policy

On 15 May 2020, the Ministry of Energy *(Secretaría de Energía) (*SENER) published a ruling establishing a new "Policy on Reliability, Safety, Continuance and Quality of the National Electric System" (the Policy). The Policy was published following a highly irregular and controversial process before the National Commission of Regulatory Improvement *(Comisión Nacional de Mejora Regulatoria)*, where SENER bypassed the mandatory notice-and-comment period established by law.

The Policy repeals and replaces a policy on reliability published by the previous federal administration in 2017, which was focused on determining parameters applicable to: (i) maximum likelihood of non-supplied energy, (ii) value of non-supplied energy, and (iii) indicative values of minimum and efficient planning. The new Policy maintains the same parameters but it goes much further, including a number of new overriding considerations and principles in pursuit of so-called "dispatch security."

The Policy establishes guidelines to be followed by the competent authorities (the Energy Regulatory Commission (*Comisión Reguladora de Energía*) (CRE) and the National Centre for Energy Control (*Centro Nacional de Control de Energía*) (CENACE), to comply with the reliability principle established in the Electricity Industry Law (*Ley de la Industria Eléctrica*) (LIE), by contributing to a rational and complete planning and operation of the National Electric System (NES).

In addition to the CRE, CENACE and *Comisión Federal de Electricidad* (CFE), the Policy requires all state and municipal governments, autonomous constitutional bodies, all administrative units and offices of SENER, and all research institutions to abide by the principles set forth therein "in order to guarantee the reliable Supply of Electricity."

Notwithstanding its alleged formal purpose, the Policy is actually focused on establishing limitations on the development, commissioning and operation of upcoming and existing renewable energy generation facilities, particularly wind and solar – technologies where private investment is predominant. Moreover, the Policy also includes a series of guidelines that may eventually affect all sorts of private generation facilities, not only those based on renewable energies.

In a nutshell, the Policy determines and/or establishes the following:

- modifications to the current dispatch criteria, by giving priority to "security of dispatch" over the economic efficiency criteria provided in the implementing regulations of the LIE, while also including the possibility of curtailing dispatch instructions for wind and solar power facilities;
- new "Ancillary Services" in order to cover the behaviour of wind and solar renewable generation facilities, establishing obligations for the latter to reimburse other generators (i.e. CFE) for the provision of those new Ancillary Services;

- new requirements and restrictions to interconnect renewable energy generation facilities – essentially suspending all ongoing interconnection applications for solar and wind projects until further notice by SENER, and allowing CENACE to reject future interconnection applications on the grounds of congestion or reliability risks;
- new planning and control guidelines for the NES, instructing CENACE to submit before SENER any activity or planning proposal related to the NES, as well as amending existing interconnection criteria and procedures;
- new requirements to grant generation permits by the CRE, including the requirement to obtain an interconnection feasibility report from CENACE as part of the permitting application process;
- new criteria to assess the feasibility of interconnection of new generation facilities, including limitations to wind and solar renewable generation facilities, and back-up capacity margins with conventional power plants (basically fossil-fuel-fired facilities);
- new priority criteria to interconnect the power plants designated by SENER as strategic facilities;
- new rules on the sufficiency of the NES, establishing parameters for operating reserves (primary, secondary and tertiary), requiring all existing and new generation facilities to participate in primary reserves, as well as criteria for planning reserves, including requirements on the variability of wind and solar renewable generation facilities;
- a new concept called "Reliable Distributed Generation", whereby certain additional technical requirements are introduced for distributed generation systems intended to be interconnected to the distribution grids, such as smart inverters with the capability to regulate frequency and voltage.

Analysis of the Policy

The Policy was issued following a similarly highly irregular and controversial ruling issued by CENACE a couple of weeks ago, which also focused on hindering the development and operation of renewable energy generation in Mexico.

Like CENACE's ruling, the Policy is in line with several previous attacks made on renewable energy generators since the current federal administration took office back in December 2018.

Unlike CENACE's ruling, however, the Policy is not predicated on the alleged slump in electric energy demand during the COVID-19 sanitary emergency, and for that reason the Policy is not intended as a temporary instrument.

While the Policy attempts to justify the legal grounds of CENACE's ruling (which had many legal deficiencies), there are multiple reasons to question its constitutionality and legality just from the point of view of domestic law.

- The Policy illegally discriminates against the generation of electricity from renewable sources to favour conventional generation sources, which are mainly controlled by the CFE.
- Using reliability of the electric system as a pretext, SENER violates its foremost responsibility to set and implement Mexico’s energy policy in line with other Constitutional principles of the Energy Reform, by illegally restricting access to competition by private players.
- SENER encroaches on the remits of other governmental agencies and entities of the federal government, and materially amends the principles established in a federal statute (i.e., the LIE) and other applicable laws, which, in turn, encroach on the authority of Congress, as required under the principles of legality and legal certainty established in the Mexican Constitution.
- The issuance of this Policy breaches international commitments of the Mexican State on climate change (click here

for a critical assessment of Mexico's performance in this area even before the adoption of the Policy and here for its nationally determined contribution to greenhouse gas emissions reduction under the Paris Agreement).

- The Policy has a retroactive effect on existing investments and development of renewable generation facilities.
- The Policy adopts disproportionate measures (using also unjustified international examples) to achieve its purpose.
- The Policy harms the general public by affecting the fundamental rights to a sustainable and healthy environment, as well as establishing principles that will affect energy prices, which will be either directly passed through to end users or indirectly subsidized with public resources that could be destined to other urgent matters.

SENER argues that the measures being introduced are all based on technical considerations aimed at assuring the reliability and security of the NES. But it is not clear how far the supposed justification for the Mexican state's actions has any basis in fact, as problems in the Mexican grid seem to be driven more by the well-known lack of investment to modernize and maintain it, rather than issues created by the intermittence of renewable energies.

There are, of course, legitimate debates to be had in any jurisdiction about the integration of "new renewables," particularly wind and solar PV, into existing electricity systems. There is always a risk that technologies initially singled out for special treatment in order to stimulate demand and pursue climate policy goals can end up being over-subsidised as the costs of new installations fall. There are also complex issues of fairness between different technologies that have to be worked out in any market-based system when it comes to allocating system costs. Each country's power system has its own features that need to be taken into account. But it is clear from precedents in Europe (e.g. the UK, Ireland and Denmark) and elsewhere (e.g., China and parts of the US and Australia) that it is possible to accommodate larger and more rapid increases in "intermittent" wind and solar generating capacity than Mexico has so far seen without losing reliability or security of power supply.

Where there are legitimate concerns about the impact of renewables on the grid, which may in certain cases include that they are undermining the economic case for new, despatchable generation such as gas turbines, there is no shortage of economic instruments that can readily be adopted to remedy the problem. But detail is everything in this context, and significant regulatory changes should only be introduced on a proportionate basis, without unjustifiably putting renewables projects out of business, or simply skewing the playing field unfairly in favour of other technologies. It is by no means clear that the Mexican authorities have subjected the measures set out in the Policy to the kind of detailed, fair and impartial economic scrutiny that they merit.

Investment treaty implications

Although there are arguably ample grounds to criticise the Policy on domestic legal grounds, for international investors in the Mexican electricity industry, investment treaties may provide a further legal tool with which to respond to the Policy, in addition to any challenge under Mexican law.

Mexico is party to a significant number of investment treaties. This includes 29 bilateral investment treaties, notably with Spain, Italy, Denmark, the UK, Korea, France, Germany, the Netherlands and China, among others, in addition to significant multilateral trade and investment treaties such as the North American Free Trade Agreement (NAFTA), its successor the United States Mexico Canada Agreement (USMCA) and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) which, to date, Australia, Canada, Japan, Mexico, New Zealand, Singapore and Vietnam have ratified.

Of particular note to US and Canadian investors, investments in Mexico made before 1 July 2020 will continue to receive investment protection under NAFTA for three additional years, until July 2023. Similarly, disputes related to those investments may also be filed under NAFTA, provided that the investment remained "in existence" on 1 July

2020 and the dispute arises from that investment. Investment protections under the USMCA are generally more restrictive than those contained in NAFTA, with recourse to dispute resolution being tiered between certain privileged government contracts in oil and gas, power generation, telecommunications, transportation and infrastructure sectors, with a less favourable dispute resolution process for all other investments. Under the USMCA, Canada is not party to the investor-state resolution provisions. However, Canadian investments in Mexico will continue to be protected by the CPTPP.

Depending on the nationality of an investor, or the jurisdiction(s) through which a particular investment is structured, investors could seek to rely on one of Mexico's bilateral investment treaties. This also includes potential reliance by indirect shareholders on Mexican investments, to whom some of Mexico's bilateral investment treaties offer protection. Investment treaties provide foreign investors with recourse to impartial international arbitration procedures to challenge measures that violate the investment protections included within them. Mexico's bilateral investment treaties provide for a number of protections, although these vary depending on the treaty in question. The protections include:

- the obligation for Mexico to treat investors' investments fairly and equitably, or in line with principles of customary international law;
- the obligation to treat investors no less favourably than the Mexican state accords its own nationals (national treatment);
- the obligation to treat investors no less favourably than a state accords to nationals of third party states (most favoured national treatment);
- the obligation to compensate, at fair market value, any expropriation of covered investments; and
- the obligation to comply with any contractual obligations assumed with regards to investments in its territory.

It appears that Mexico's renewable energy measures could raise questions in relation to compliance with Mexico's investment treaty obligations. For example, investors may seriously question whether Mexico's measures provide investors with fair and equitable treatment, including treatment in line with their legitimate expectations. Further, the measures may have an expropriatory effect on certain investments or an effect that is akin to expropriation. Additionally, questions remain as to the actual effect of these measures and whether they impact foreign investors on an equal footing to Mexican renewable energy producers.

Investors do need to be mindful that recourse to the dispute resolution mechanism offered under Mexico's bilateral investment treaties could be impeded if they opt to pursue court proceedings against the measures in Mexico's domestic courts. This is because some of the investment treaties include fork-in-the-road or waiver provisions, which prevent an investor from utilizing the arbitration mechanism if it has already challenged the measures before a domestic court. Not all of Mexico's investment treaties contain such a provision, so it is important to assess any dispute resolution options carefully by considering the position under the relevant treaty.

How we can help

As noted above, sudden changes in renewable energy policies have prompted legal action against governments and regulators in a number of jurisdictions globally. In terms of investment treaty disputes, claims have been made against Spain, Italy, the Czech Republic and Canada, among others.

Dentons is widely acknowledged as having one of the leading energy law practices in Mexico. Our global disputes practice also has particular strengths in investment treaty disputes and has represented investors in a number of

claims arising from changes in renewable energy regimes. In addition, our global experience of the renewables industry and of advising governments and regulators on market reform programmes means that we are well placed to draw comparisons between Mexico's approach and international best practice. We are therefore ideally placed to advise any investor wishing to assess its potential avenues of recourse or contemplating legal action in response to the Policy.

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