The undoing of Mexico's competitive liberalization:

The electric industry, rule of law and investment

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Executive summary

AMLO's electric reform threatens to undo Mexico's process of competitive liberalization and its commitment to the rule of law. The law reflects a shift in the country's direction beyond the energy sector that reveals an underlying trait of the current administration's worldview: the retreat of Mexico as a major promoter of the rules-based international trade governance.

The spirit and letter of the reform to the Electric Industry Law is to dismantle incentives for private investment in electricity generation without *de jure* eliminating the Wholesale Electricity Market through four critical amendments:

1) altering the energy dispatch pecking order from one of economic merit to one based on ownership that benefits CFE over private firms;

2) eliminating incentives to expand renewable infrastructure by removing the requirement for power plants with operation start dates post 2014 to issue Clean Energy Certificates (CELs);

3) discouraging investment by eliminating the obligation of CFE's commercialization division to buy energy through auctions or competitive processes; and,

4) granting the Energy Regulatory Commission (CRE) the ability to revoke self-supply permits (*autoabasto*).

The reform violates Mexico's commitments contained in the North American Free Trade Agreement (NAFTA), the United States-Mexico-Canada Agreement (USMCA), the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) and the modernization of the Mexico-European Union Free Trade Agreement (ratification pending) regarding market access, investment, State-owned enterprises and designated monopolies, environment, among other provisions.

The reform also threatens $26 billion USD in private investment in renewable generation. Hence, the amendments to the Electric Industry Law pose a risk for public finances, not only through higher electricity costs, but also due to the cost of potential compensation to investors.

The success in renegotiating NAFTA and saving the North American trade partnership through the USMCA will turn meaningless if the Mexican government does not understand the value of a predictable environment where investors have the certainty that their lawful rights will not be threatened by the political fluctuations of the time. Moreover, a truly successful trade partnership requires parties to actively promote these principles. Mexico's rejection of its international commitments sets a negative precedent for a country that was a major promoter of the rules-based trade governance during the last three decades.

Introduction

The law proposed by President Andrés Manuel López Obrador (AMLO), recently passed by Congress and published in the Official Gazette, to amend Mexico's Electric Industry Law reverses the cornerstones of the liberalization in power generation. The reform will have a significant impact in public finances and in the financial health of the State-owned utility - the Federal Electricity Commission (CFE). The main risk, however, is sending the message that the Mexican State is not willing to live up to its commitments in international agreements.

Ever since Mexico's accession to the General Agreement on Trade and Tariffs (GATT) in 1986 and especially after the entry into force of the North American Free Trade Agreement (NAFTA) in 1994, trade openness has become one of the few consistent State policies in a country where typically new administrations attempt to unwind their predecessor's legacy. Different governments, regardless of political parties or ideologies, have ascertained the value of strengthening the country's competitiveness through economic liberalization by expanding Mexico's network of trade agreements deploying a strategy that former United States Trade Representative Robert Zoellick has called competitive liberalization.

Countries that adopt this approach pursue economic openness through four complementary pillars: 1) unilaterally reducing barriers to trade and investment; 2) negotiating bilateral trade deals; 3) joining plurilateral agreements that lower barriers for a specific sector; and 4) engagement in the multilateral realm, i.e., the World Trade Organization. An indispensable condition for competitive liberalization to be successful is a strict adherence to the provisions of different institutional frameworks, which reduce governments' room for maneuver in economic arrangements.

The primary pillar of Mexico's competitive liberalization was North American regional integration. The enactment of NAFTA meant that, for the first time in its history, the country committed to respect the rule of law in the international trade sector of the economy and in foreign investment. Barriers to trade and investment, however, prevailed in a range of sectors, from telecommunications to energy. In order to fully harness Mexico's geographical location and its network of free trade agreements (FTAs) as the country's main comparative advantage, there was a need to address the first pillar of competitive liberalization: unilaterally lowering barriers to trade and investment. The process of sectoral liberalization reached its peak during the Peña Nieto administration (2012-18) through the reform agenda backed by a multiparty coalition known as *Pacto por México* (which encompassed energy, competition, telecommunications, labor, anti-corruption, transparency, among other issues). A landmark component of this unilateral liberalization was the opening of the power industry to private investment in the generation and commercialization segments in 2013-14.

AMLO's electric reform threatens to undo Mexico's process of competitive liberalization and its commitment to the rule of law. The law reflects a shift in the country's direction beyond the energy sector that reveals an underlying trait of the current administration's worldview: the retreat of Mexico as a major promoter of the rules-based international trade governance.

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I. Reversing unilateral liberalization: a return to the State-owned monopoly

The spirit and letter of the reform to the Electric Industry Law is to dismantle incentives for private investment in electricity generation without *de jure* eliminating the Wholesale Electricity Market through four critical amendments.

First, it alters the energy dispatch pecking order from one of economic merit to one based on ownership that benefits CFE over private firms. The goal is to dispatch electricity from CFE plants first, regardless of the cost. The main losers of this proposal, from a generation standpoint, are renewable and clean energy plants, which would be dispatched last. Typical market pricing signals are blurred by the proposed dispatch order and are exceedingly difficult to infer. The new dispatch mechanism gives priority to CFE generating plants; hydro first, then other thermal CFE plants, then private wind and solar generation and at the very last, private combined cycle plants.

As CFE's hydroelectric plants cannot satisfy the country's electricity demand, the main beneficiaries would be CFE's technologically obsolete, polluting plants that take second place on the dispatch list. By doing so, the incentive to buy and use the cheapest electricity first is removed. Efficiency from competition is halted, price signals are blurred, and certainty is eroded. The incentive to integrate renewables disappears since the amendment prioritizes fossil-fuel fired plants owned by CFE.

Second, the reform eliminates incentives to expand renewable infrastructure by removing the requirement for power plants with operation start dates post 2014 to issue Clean Energy Certificates (CELs). In order to encourage clean energy, the Energy Transition Law created a mechanism where a CEL is awarded for each megawatt-hour of energy generated by clean energy power plants that started operations after August 2014. The new law benefits CFE by granting certificates to plants operating prior to 2014. Recognizing the challenge posed by climate change, the 2013-2014 reform focused on promotion of new clean energy power plants. The new legislation destroys that incentive, disproportionately favors CFE and makes it impossible to for Mexico to comply with its international commitments under the Paris Agreement. Essentially, a CEL would become much less valuable thus reducing the value of renewable investments already in place and discouraging newer ones.

Third, the reform discourages investment by eliminating the obligation of CFE's commercialization division (*CFE Suministrador de Servicios Básicos* or *CFE SSB*) to buy energy through auctions or competitive processes. CFE SSB is responsible for supplying electricity to residential, rural, and low volume industrial and commercial users. Up to now, it was obligated to buy its energy through a competitive process to ensure the lowest cost of energy and the lowest possible impact both on consumer bills and public finances. The new law not only promotes opacity but also creates a burden for both CFE's and Mexico's public finances. It does not offer incentives to minimize cost and it allows CFE SSB to bypass the Wholesale Electricity Market to favor its own plants, regardless of cost or efficiency. At the same time, the government has made it clear it does not intend increase household electric bills. Only a growing public subsidy will close the widening gap that will result.

A fourth relevant change to the electric system is that the reform gives the Energy Regulatory Commission (CRE) the ability to revoke self-supply permits (*autoabasto*). Before the sector's liberalization, this mechanism allowed private firms to produce their own electricity and to supply their partners. After Mexico's landmark 2013-14 energy sector reform, self-supply permits became vested contracts for the remainder of their lifespan. The amendment establishes that self-supply permits grandfathered by the Electric Industry Law may be revoked by the CRE if they were found to have been "fraudulently assigned". This regulation opens an unnecessary front, since the self-supply model will disappear once permits expire and generation capacity is limited by the original capacity established in the permits. Hence, the impact on the market is negligible, especially, if the reform's fundamental objective is to eliminate the market and its signals in the first place. The impact on investors' certainty, nonetheless, is significant, given that

it reduces trust in Mexico's commitment to the rule of law by making a legal amendment retroactive. The objective is rather apparent: to close to door for private generation on almost any front.

II. A farewell to predictability: the power industry, international trade, and rule of law

The great success of NAFTA 27 years ago was predictability; the certainty for investors that the Mexican government would not alter the legal and regulatory framework under which an investment was made in the first place. The electricity reform is arguably the most significant challenge to this predictable environment from which Mexico has benefited greatly during the last three decades. This is not an overstatement. It is the first time that both the executive and legislative branches of government have endorsed legal amendments that shamelessly violate the country's FTA commitments (and Mexico's Constitution). In a nutshell, the reform represents an indirect expropriation. It makes it very difficult to operate assets and significantly changes the conditions in which investments were and are made.

If the Mexican government insists on moving forward with the implementation of the reform, public finances would be hard hit, not only by higher electricity costs, but also due to the cost of potential compensation to investors. According to the Business Coordinating Council (CCE), Mexico's most important private sector organization, the reform to the Electric Industry Law threatens $26 billion USD in private investment in renewable generation.

AMLO has insisted that the energy sector is not an integral part of NAFTA's successor, the United States-Mexico-Canada Agreement (USMCA). This statement is not only false, but also an underestimation of the country's energy commitments in its FTA network. The liberalization of the electric industry is an integral part of the USMCA, the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) and the modernization of the Mexico-European Union Free Trade Agreement (ratification pending). Moreover, it was already partly consolidated in the original NAFTA.

In more than one way, at the time of its enactment, NAFTA was a revolutionary agreement. It was the first FTA between two developed and one developing economy that incorporated symmetry and universality. This is to say, there was no special and differential treatment for the least developed party, Mexico, and thus it implied a broad opening but for the exceptions on services and investment explicitly reserved in the annexes. Mexico for the first time won the argument that it had to be treated as an equal by its peers. NAFTA also meant that once a sector was liberalized for investment or services, even unilaterally, this openness would become an integral part of the agreement due to the negative list approach and the *ratchet clause* (11.08 (1)(c) and 12.06 (1)(c)). Hence, after the 2013-14 energy reform, investments in the electricity sector were protected under the provisions of NAFTA's chapters 11 and 12, including the Investor-State dispute settlement mechanism (ISDS), which covers direct and indirect expropriations. The USMCA expanded these protections through a series of cross-references.

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The Mexican government's position that chapter 8 on energy recognizes Mexico's ability to unilaterally modify its Constitution and secondary legislation on energy is inaccurate. First, the USMCA's chapter 8 does not refer to electricity, but to hydrocarbons. Second, Article 8.1(2) states

that the United States and Canada recognize that Mexico reserves its sovereign right to reform its Constitution and its domestic legislation, “without prejudice to their rights and remedies available under this Agreement”. The latter phrase is crucial to understand the extent to which Mexico can modify its domestic law without incurring a violation of the chapter and opening the door to the possibility of State-State panels.

The amendments to the Electric Industry Law aim to benefit the State player over all other market participants through the new dispatch order, the new criteria to grant CELs, and by discouraging energy purchases through auctions. These are flagrant violations of the Mexican Constitution and the USMCA and CPTPP chapters on State-owned enterprises (SOE) and designated monopolies, which establish that SOEs must act according to commercial considerations in a non-discriminatory manner in their purchases and sales of goods or services (USMCA: 22.4; CPTPP: 17.4).

Both the USMCA and CPTPP include a commitment to guarantee the independence of the energy regulator (USMCA: 22.05 (2); CPTPP: 17.5 (2)). The reform makes it increasingly difficult for Mexico’s CRE to be truly independent, especially due to the transitory article that instructs CRE to revoke self-supply permits that were fraudulently obtained. The e*x-ante* assumption that self-supply permits are fraudulent is a threat to the due process and makes it difficult for CRE to determine what is a fraudulently obtained permit.

The USMCA maintains NAFTA’s negative list approach and includes the *ratchet clause* in its investment chapter (14.12 (c)). Although the ISDS mechanism was diluted in USMCA, the new dispute settlement mechanism between Mexico and the United States for covered government contracts established in USMCA’s annex 14-E retains the key protections of NAFTA’s ISDS – national treatment, most favored nation treatment, and direct expropriation – as well as indirect expropriation for six sectors, including electricity. Likewise, the USMCA’s grandfathered investments may use NAFTA’s ISDS provisions for a period of three years from July 1, 2020. Moreover, chapter 11 of NAFTA applies for investors during the first three years of USMCA.

CPTPP is the only FTA ratified by Mexico that includes an energy chapter where the 2013-14 liberalization is incorporated (unlike NAFTA where it was consolidated through the *ratchet clause*). The USMCA anticipates the same level of openness as CPTPP through article 32.11, which states that regarding obligations in investment, cross-border trade in services and SOEs “Mexico reserves the right to adopt or maintain a measure with respect to a sector or sub-sector for which Mexico has not taken a specific reservation (…), only to the extent consistent with the least restrictive measures that Mexico may adopt or maintain under the terms of applicable reservations and exceptions to parallel obligations in other trade and investment agreements that Mexico has ratified prior to entry into force of this Agreement”.

Given that CPTPP was ratified before the enactment of the USMCA, this implies that the liberalization of the energy sector included in the former is also an integral part of the latter. CPTPP’s Annexes I and II include Mexico’s reserves for electricity, which in accordance with the Mexican Constitution, include the planning and control of the system, as well as the public services of electric transmission and distribution. In other words, Mexico did not reserve power generation in those annexes and thus it cannot now back track on its opening to private sector investment without violating both its CPTPP commitment and, through it, USMCA article 32.11.

The environmental chapters of both the USMCA (24) and CPTPP (20) have not been subject of discussion regarding the reform to the Electric Industry Law. Nonetheless, they could potentially represent powerful instruments against Mexico’s rejection of the energy transition. Both chapters include commitments under which parties may have to defend their policies in international panels if they “fail to effectively

enforce its environmental laws through a sustained or recurring course of action or inaction in a manner affecting trade or investment between the parties". The phrasing of these provisions is critical for the amendments to the electricity legal framework. While the Mexican government could argue that it is living up to this commitment, since the Electric Industry Law has been reformed, it would still violate the Energy Transition Law, which establishes that Mexico must produce 35% of its electricity through clean sources by 2024 (a commitment included in the 2015 Paris Agreement). The enactment of the electric reform seemingly implies a lack of concern for this provision and, furthermore, it would be possible to argue that the same amendments that will likely make this objective unachievable, also affect trade and investment since they effectively make the operation of clean electric generation assets in the country unfeasible.

Beyond the USMCA and CPTPP, Mexico is currently in the process of modernizing the trade pillar of the country's Global Agreement with the European Union. An agreement-in-principle was achieved in 2018 that includes stringent provisions for the energy sector on regulatory transparency, market access and non-discrimination, as well as regulatory independence. The reform will likely complicate the completion of the modernization, including its signing and ratification.

III. Conclusions: a blueprint for a North American energy market

The publication of the reform in the Official Gazette on March 9, 2021, was followed by an avalanche of legal challenges from affected companies and private citizens claiming legitimate interest. At the time of publication, a definitive stay against the implementation of the law has been granted, however the outcome of these legal battles is still uncertain and will likely be defined by a ruling of the Supreme Court.

The reform of the Electric Industry Law, even if it were to be overruled by the Court, represents a U-turn in Mexico's path towards competitive liberalization. This reversal has negative implications for regional competitiveness. For Mexico this means a lost opportunity to further integrate in one of the most competitive regional energy markets: North America.

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International trade relies on principles that parties agree to respect and promote. It took a long time for Mexico to ascertain that only by playing by the rules the country could compete and succeed in global markets. The results are visible in the regions that were able to become "North American" in the economic sense. President López Obrador has been clear in his goal of developing Mexico's poorest and most under-served regions, especially in the country's south-southeast. The reform undermines this objective by discouraging all investment in the Mexican economy. A better approach would be to harness the competitiveness of North American energy markets to catalyze development in these states by promoting investment in energy infrastructure. Without reliable access to electricity, these regions will not be able to insert themselves into the North American supply chain.

In the USMCA, Canada and the United States signed a side-letter on energy cooperation that offers a roadmap to enhance Mexico's competitiveness in the energy sector by guaranteeing the independence of energy regulators, promoting the integration of energy markets and regulatory transparency.

Mexico could even go one step further and promote the integration of energy markets by promoting an expansion of the mandate of the North American Development Bank (NADBANK) to include energy-related projects, as proposed by the Mexican Council on Foreign Relations in a 2017 working paper.

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About the author

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Ocampo studied Political Science at Universität Hamburg and holds a Master's degree in Public Policy from the London School of Economics and Political Science.