The next wave of ISDS cases could be ‘powered’ by recent policy changes in the renewable energy sector in Mexico

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Introduction

Turbulent times lay ahead for private investors in the renewable energy sector in Mexico. Due to mounting policy changes by the federal administration over the past couple of years, some already speak of the death by a thousand cuts of the privately-owned renewable energy projects in Mexico. These changes range from the cancellation of long-term auctions to triple-digit increases in the transmission fees and changes to the operational rules. They are all financially burdensome for renewable energy producers and apparently designed to favour the giant state-owned Federal Electricity Commission (CFE) and maintain its market dominance.

Mexico’s international commitments related to climate change and the transition to clean energy seem to have been pushed aside – at least for now – and the market conditions created to attract foreign investment to the sector might soon be a thing of the past.

As private investors move forward with legal challenges before Mexican courts and lobbying efforts before the federal government, the outcome is still unclear. However, it is not hard to imagine that foreign investors, who make up for a significant share of the industry, will soon resort to investment arbitration to recover the losses they will likely suffer, should the policy changes remain in place or worsen in the near future.

Considering the number of affected parties and the significant amounts invested in renewable energy projects all over the country, Mexico could end up as respondent in a wave of new investor-state cases and on the hook to pay hundreds of millions – if not billions – of dollars in compensation to the investors left with financially unviable enterprises.

Most of these foreign investments were made under the protection of the broad network of bilateral investment treaties signed by Mexico, which guarantee that the investors will be duly indemnified for the losses caused by governmental decisions in breach of the standards of protection established in those treaties.

It would not be the first time a sudden change in a country’s policy on renewable energy results in a wave of Investor State Dispute Settlement (ISDS) cases. It happened to Spain during the last decade after it decided to enact a series of measures that effectively suppressed the economic incentives created to boost the renewable energy sector. The results of that political decision are still unfolding, with at least 47 proceedings having been initiated so far, and many still pending before arbitral tribunals.

Mexico could learn from the lessons of the Spanish case. It might not be too late to correct course and design sensible policies that both advance the agenda of the current administration, and protect the economic interests of private investors, allowing their projects to provide cleaner energy for the Mexican market.

Private investment in the electricity sector

Private investment is not something new for the electric industry in Mexico, although for decades the state-owned electric utilities held a monopoly and constitutional provisions forbade any form of private investment in the sector.

During the first decades of development of the electric industry in the country, in the 19th century, almost all projects were financed by private parties. The first power plant – a thermoelectric plant – was established by the owners of the textile factory 'La Americana' in Leon, Guanajuato in 1879, followed by a privately-owned hydroelectric plant – with a modest installed capacity of 22 kW – in Batopilas, Chihuahua in 1889. During the decades that followed, there was a significant inflow of foreign investment, mainly from the United States and Canada, to establish power plants in different regions of the country.[1]

After an initial period of investments by small players, the market came to be concentrated in the hands of three big companies: the Mexican and Light Power Company, which had Canadian capital and dominated the central part of Mexico; the American and Foreign Power Company,[2] which had US capital and mainly focused on the northern part of the Mexico; and the Compañía Hidroeléctrica e Irrigadora del Chapala SA, which had both Mexican and foreign capital and was focused on the west of the country.[3]

In 1937, the administration of President Lazaro Cardenas created the Federal Electricity Commission (CFE), a public electric utility which was charged with bringing electricity to all areas of the country, even those remote rural villages that private companies were not interested in connecting to the grid due to the high cost of the required infrastructure. Backed by the resources of the federal government, CFE completed important projects and steadily acquired the assets of the foreign companies.

By the end of the 1950s, CFE owned 54 per cent of the existing power generation industry in Mexico. The other participants by that point were the Canadian-owned Mexican Light and Power Company, with 25 per cent, Impulsora de Electricidad, with 15 per cent, and other smaller companies with the remaining nine per cent of Mexico's installed capacity. By 1960, the Mexican Government had acquired all of the major companies.

The strategy to take over the electric industry was finally consolidated when article 27 of the Constitution was amended, on 29 December 1960, to establish that electrical power generation, transformation, distribution and supply were public services, reserved exclusively for the state and state-owned companies, and to prohibit the granting of any concession to private parties. For the three decades that followed, the state-owned CFE and Luz y Fuerza del Centro were the only participants in the market (Luz y Fuerza del Centro would eventually be dissolved, with CFE remaining as the only utility in the country).

By the early 1990s, Mexico was visibly shifting from the import-substitution, closed-economy model to a more open, global economy, seeking to attract foreign investment and betting on free-trade agreements with its commercial partners. Also, due to recurrent economic crashes and massive devaluations, the government no longer had the resources to develop new power generation projects and to modernise the outdated technology used in the electricity industry.

In 1992, the administration of President Salinas de Gortari decided to take a modest first step towards allowing private investment in the energy sector. The Electric Power Public Services Act was amended to allow private parties to generate electric power to be sold to CFE, used for self-supply, or exported. Under this regime, public biddings resulted in the execution of long-term power-purchase agreements with investors who developed generation projects all over the country. Most of those projects were combined cycle power plants. This provided the electric industry with a much-needed breath of fresh air, since these modern plants produced cheaper and cleaner energy and with a significantly higher installed generation capacity.

The degree of participation of private investors in the market remained unchanged over the next two decades, until the biggest political parties aligned to pass the 2013 'Energy Reform', completely changing the regulatory framework.

Energy Reform and investment flow in the renewable energy sector

The Energy Reform passed in 2013 was an important step towards opening the electricity market to private participants, attracting investment, and creating competition. While CFE retained a monopoly over the transmission and distribution services, the legal framework was significantly modified to allow private investors to participate in almost every other aspect. As part of the Energy Reform, highly attractive incentives were designed for renewable energy projects, among them the introduction of clean energy certificates. These certificates would be assigned to generators with clean energy sources and could be sold in the open market.

President Peña Nieto enthusiastically declared that the Energy Reform was a 'green reform' and that with its entry into force, the barriers that prevented Mexico from growing rapidly and steadily had been broken down.[4] The new legal framework generated interest both within and outside of Mexico and it soon attracted an influx of investment to the sector.

The right conditions existed. The new market rules and economic incentives made power generation projects – and especially renewable energy projects – financially attractive. Further, Mexico had built an ambitious network of more than 35 bilateral investment treaties and 15 free trade agreements providing guarantees of protection for foreign investors. This was further reinforced by Mexico's signing of the International Centre for Settlement of Investment Disputes (ICSID) Convention in 2018.

During the first few years of the new legal regime, there was an important flow of investments in the renewable energy sector. Many international big players and domestic investors participated in public biddings and developed projects throughout the country. According to some sources, investments in the renewable energy sector amounted to more than US$9bn.[5]

The federal administration changes course

After the federal elections of 2018, a new political party won the presidency and a majority in Congress. With a political agenda markedly different from those of previous administrations, the existing structural policies and political decisions soon began to be questioned. President Lopez Obrador had been an outspoken critic of the Energy Reform before the election, and almost immediately after assuming office his administration began to implement a series of measures that could substantially change the market conditions in the electricity market and financially affect private investors.

It started early in 2019, when the federal government cancelled two of the biggest pending projects in the electricity sector, related to the construction of much needed transmission lines to connect the region of Tehuantepec in southeast Mexico and the Baja California peninsula.[6]

Later, in October 2019, the Ministry of Energy published a decree modifying the rules applicable to clean energy certificates, which were intended to incentivise investment in renewable energy projects.[7] Under the new rules, clean energy certificates are assigned not only to new sustainable projects – as was originally intended – but also to the already existing plants owned by CFE. This could result in the market suddenly being flooded with clean energy certificates, thereby significantly diminishing their value. As many projects based their financial projections on the expected value of the certificates under the previous rules, their viability could be in jeopardy.

By the end of 2019, a list of demands submitted to the federal government by CFE was leaked. In that document, CFE detailed the amendments and new policies that CFE considered necessary to maintain its dominance in the electricity sector and to compete with private investors. This leaked document created great uncertainty, as it was unclear whether the changes requested by CFE would, in fact, be implemented. Only a few months later, some of them were.

In April 2020, in the midst of the pandemic caused by COVID-19, the National Energy Control Center issued a resolution suspending pre-operative tests and imposing limits to the transmission of energy produced by solar and wind power plants, alleging that their instability created risks for the National Electric System.[8] Days later, the Ministry of Energy issued a Reliability Policy, in which it was established, among other things, that:

- the Ministry may discretionally define strategic projects that will enjoy priority status with respect to their interconnection to the National Transmission Network;
- new and extended interconnection contracts must include the possibility of early termination;
- plants need to obtain a new interconnection viability certification; and
- wind and solar plants are required to guarantee the control of voltage at all times.[9]

Most recently, in June 2020, CFE announced an increase of between 500 and 800 per cent to the fees charged for the transmission of power generated by solar and wind plants, which was immediately confirmed by the Energy Regulatory Commission.[10]

The official reasons for taking those measures are related to the stability and security of the National Electric System. However, some high-ranking members of the government, including the President, have made public statements implying that their real purpose is to prevent private parties from taking an allegedly unfair advantage of the new market and legal conditions created as part of the Energy Reform and to help CFE to maintain its competitive advantage and market dominance.[11]

Cumulatively, the measures implemented by the federal government impose a considerable burden on private investors in the sector, but especially on renewable energy producers. Should the measures remain in place, the economic consequences could be severe enough as to make projects financially unviable.

Many market participants reacted swiftly and immediately filed constitutional protection actions – *amparos* – before Federal District Courts, seeking a declaration that the measures are unconstitutional and are not to remain in force. These proceedings remain pending at the time of writing. Some judges have already granted injunctions, signaling that the judiciary is skeptical as to the legality of the measures and willing to hear the arguments advanced by the investors.

In parallel, foreign investors have reached out to their governments to resolve the issue through diplomatic channels, and some are already considering the possibility of filing investment arbitration claims against Mexico. The number of foreign companies whose investments are protected under bilateral investment treaties or investment chapters of free trade agreements is so large that if the measures implemented by the Mexican Government remain in force – or become even more detrimental to participants – Mexico could face a wave of investor-state cases that could lead to the country having to pay hundreds of millions in compensation to investors.

Lessons from the Spanish case

Over the past decade, Spain has experienced a wave of investor-state cases, arising precisely because of a change in the country's policies in relation to the renewable energy sector around 2010. In fact, the number of cases is so high that Spain is now the second most frequent respondent-state in ISDS cases – only behind Argentina.[12] Many of those cases are still pending, but some relevant lessons can be learned from them.

The Electricity Law No 54/1997 divided the generation of electricity in Spain into two different regimes: the ordinary regime, which applied to conventional generation facilities, and the special regime, which applied to renewable sources of power generation. While ordinary regime generators received only the market price, special regime generators received a state subsidy or premium. Secondary regulations created a series of incentives that were designed to boost the renewable energy sector.

Under these attractive conditions, foreign investors developed important renewable energy projects, expecting a reasonable rate of return. However, from 2010 onwards, the Spanish Government enacted a series of measures that had the effect of significantly reducing the level of economic incentivisation for renewable energy producers and, thus, the rate of return for investors, lowering the value of their investments and the profitability of their projects. Among those measures, the Electricity Sector Law 24/2013 eliminated the distinction between the ordinary and special regime, under the premise that renewable energy producers no longer lacked the ability to compete in the market with producers using conventional sources.

Over the past eight years, many foreign investors have initiated investment arbitration proceedings against Spain, seeking compensation for the losses caused by this change in the legal regime. Most cases have been filed under the Energy Charter Treaty.

One of the first cases was filed by the so-called 'PV Investors', a group of 26 investors from Denmark, Germany, Ireland, Luxembourg, the Netherlands, and the United Kingdom, who developed photovoltaic installations representing an aggregate of 239.338 MW of electrical power-generating capacity. They claimed more than €1.9bn in damages, and although the arbitral tribunal – chaired by Gabrielle Kaufmann-Kohler – dismissed some of their claims and limited their compensable damages, they received a compensation of €9.1m. The tribunal concluded that Spain had breached article 10(1) of the Energy Charter Treaty and violated the guarantee of a reasonable rate of return afforded to investors.[13]

So far, more than 47 cases have been brought against Spain and although many of them remain pending, the country has already been ordered to pay sums of compensation as high as €290.6m.[14]

In those cases, arbitral tribunals have, in general, recognised that states have a right to regulate and adapt their framework to changed circumstances, and they afforded Spain a certain leeway to modify the applicable law in response to bad economic conditions and an increase in electricity rates. However, they concluded that the measures had to comply with the standards of protection established by the applicable international treaties, principally fair and equitable treatment (including legitimate expectations) and full protection and security, and that the measures should not be unreasonable, arbitrary, disproportionate or discriminatory.[15]

Those same standards of protection, with certain differences depending on the specific applicable treaty, are included in the bilateral investment treaties and free trade agreements signed by Mexico. This means that if investors were to initiate investment arbitration proceedings against Mexico, each measure taken by the federal administration would be reviewed under those standards.

This is perhaps the main lesson that can be learned from the Spanish case. Validly enacted changes to the legal regime are not per se a violation of the standards of protection and the state is not obliged to maintain the exact same conditions prevailing when an investment was made – unless it made specific assurances to investors – as long as the right to regulate and adapt the legal framework is exercised in a manner that is proportionate, reasonable and non-arbitrary or discriminatory.

On this latter point is where the Mexican Government could encounter severe difficulties in justifying the measures taken and avoiding having to pay considerable amounts in compensation to foreign investors. Arguments have been raised that these measures were invalidly and arbitrarily enacted, that they lack sufficient technical or economic justifications, and that they appear as a simple retaliation by way of discriminatory treatment against private participants and as part of a strategy to benefit CFE. If these arbitration disputes are initiated, it will be interesting to see how arbitral tribunals rule on these arguments.

Conclusions

The administration of President Peña Nieto introduced the Energy Reform in 2013, creating market and legal conditions designed to attract private investment to the energy sector and in particular favour renewable energy to facilitate the transition towards cleaner energy sources. This resulted in an inflow of private investment for Mexico, most of which came from North America, Europe, and Japan, and are therefore protected under bilateral investment treaties and investment chapters of Free Trade Agreements.

The federal administration, in what has been seen by some as an effort to benefit the state-owned Federal Electricity Commission (CFE), has implemented several changes to the rules applicable to the electric industry, which will likely result in major losses for renewable energy producers and might even make some of their projects financially unviable.

If domestic remedies and the investors' negotiating efforts turn out to be unsuccessful, Mexico might be the respondent state in a new wave of ISDS cases, and could be liable for billions of dollars in compensation to be paid to foreign investors. There are some parallels with the most recent wave of ISDS cases against Spain, also caused by a change in policies applicable to the renewable energy sector. Both the investors and the government could take advantage of the lessons from the Spanish cases, as there might still be time to avoid the impending crisis.

Notes

1. Enrique de la Garza Toledo et al, *Historia de la Industria Eléctrica en México* (1994).

2. The American and Foreign Power Company was incorporated in 1924 by the American Utility Electric Bond & Share Company (EBASCO) – controlled by General Electric – to carry out foreign expansion. It developed projects and acquired assets in Ecuador, Costa Rica, Chile, Argentina, Mexico, Brazil, India, and China, among other countries.See William J Hausman & John L Neufeld, *The Rise and Fall of the American & Foreign Power Company: A Lesson from the Past?*,10 The Electricity J 46 (1997).

3. See Sergio Valerio Ulloa, *Empresas, tranvías y alumbrado público. La compañía Hidroeléctrica e Irrigadora del lago de Chapala*, in Poder público y poder privado. Gobiernos, empresarios y empresas, 1880–1980, 252 (María Eugenia Romero Ibarra et al 2006).

4. Enrique Peña Nieto, *Reforma Energética para un Nuevo México* (2014), www.sct.gob.mx/despliega-noticias/article/reforma-energetica-para-un-nuevo-mexico.

5. Arturo Solis, *En Mexico ya hay más de 130 plantas de energía solar y eólica* (2020), www.forbes.com.mx/mexico-tiene-mas-de-130-plantas-de-energia-solar-y-eolica/#:~:text=7%3A00%20am-,En%20M%C3%A9xico%20ya%20hay%20m%C3%A1s%20de%20130%20plantas%20de%20energ%C3%ADa,por%209%2C000%20millones%20de%20d%C3%B3lares.

6. Karol Garcia, *Cancelan megaproyectos de transmisión eléctrica* (2019), www.eleconomista.com.mx/empresas/Cancelan-megaproyectos-de-transmision-electrica-20190130-0004.html.

7. *Secretaría de Energía, Acuerdo por el que se modifican los Lineamientos que establecen los criterios para el otorgamiento de Certificados de Energías Limpias y los requisitos para su adquisición*, publicados el 31 de octubre de 2014 (28 October 2019).

8. El Centro Nacional de Control de Energía (CENACE), *Acuerdo para garantizar la eficiencia, calidad, confiabilidad, continuidad y seguridad del Sistema Eléctrico Nacional, con motivo del reconocimiento de la pandemia de enfermedad por el virus SARS-CoV2* (COVID-19) (29 April 2020).

9. *Secretaría de Energía, Acuerdo por el que se emite la Política de Confiabilidad, Seguridad, Continuidad y Calidad en el Sistema Eléctrico Nacional*(15 May 2020).

10. CFE, Aviso Ref: 495591 (10 June 2020); *Comisión Reguladora de Energía, Procedimientos para determinar las variables económicas requeridas para el cálculo de los cargos por servicios de transmisión a tensiones mayores o iguales a 69 kV, que aplica CFE Intermediación de Contratos Legados, SA de CV* (12 June 2020).

11. See, eg, Aristegui Noticias*, Asegura AMLO que algunos negocios de energía renovable eran sucios* (2020), https://aristeguinoticias.com/1805/mexico/asegura-amlo-que-algunos-negocios-de-energia-renovable-eran-sucios-amlo; Alonso Urrutia and Nestor Jimenez, *AMLO: ya no habrá contratos leoninos con energía limpia* (2020), www.jornada.com.mx/ultimas/politica/2020/05/19/amlo-ya-no-habra-contratos-leoninos-con-energia-limpia-9168.html; *Sin Embargo, AMLO: Funcionarios y empresas defraudaron con contratos de energía, y se les va a denunciar* (2020), www.sinembargo.mx/30-06-2020/3814561.

12. UNCTAD, 'Investor-State Dispute Settlement Cases Pass the 1,000 Mark: Cases and Outcomes in 2019', at https://unctad.org/en/PublicationsLibrary/diaepcbinf2020d6.pdf.

13. *The PV Investors v Spain*, PCA Case No 2012-14, Final Award 28 February 2020.

14. *NextEra Energy Global Holdings BV and NextEra Energy Spain Holdings BV v Kingdom of Spain*, ICSID Case No ARB/14/11, Final Award, 31 May 2019.

15. See, eg, *The PV Investors v Spain*, PCA Case No. 2012-14, Final Award 28 February 2020; *Infrastructute Serives Luxembourg, Sarl and Energía Termosolar, BV v Kingdom of Spain*, ICSID Case No ARB/13/31, Award, 15 June 2018; *Masdar Solar & Wind Cooperatief UA v Kingdom of Spain,* ICSID Case No ARB/14/1, Award, 16 May 2018.

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