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The Mexican Energy Counter-Reform: State Defense and Damages (Tenth Investment Arbitration Forum: Part II)

Arthur Tochetto Dal Piva, Maria Victoria Ferraz · Wednesday, November 3rd, 2021

On 30 June and 1 July 2021, the Tenth Investment Arbitration Forum took place in form of a webinar jointly organized by Dr. Herfried Wöss of Wöss & Partners and Prof. Dr. Guillermo Estrada Adán of the Instituto de Investigaciones Jurídicas, UNAM.

The topic of this year's forum was "The Second Mexican Energy Reform" and the impact of the multiple regulatory and legal changes by the Mexican government on energy investments and different investment arbitration scenarios.

State Defense

Ricardo Ampuero, former President of the Special Commission for Investment Disputes of Peru, mentioned that investors are not interested in international investment arbitration, but rather in the good development of the investment.

The main issues states face in arbitrations are: (i) the auto-compositive methods of dispute resolution are more complicated to be accounted for when considering the agreement on compensation; (ii) the sector to which the company belongs could use the case discussed as a precedent and develop a chain reaction of subsequent arbitrations against the state; and finally, (iii) there is no regulatory framework that provides a secure method of negotiation without exposing the state to possible claims.

He pointed out that states should have a mechanism of prior alerts, in which any agency of the state could warn the beginning of a claim; the centralization of information would ease defense, as well as the suppression of confidentiality for an open discussion of defense strategies.

Ignacio Suárez-Anzorena, of Suárez-Anzorena Arbitration, presented three scenarios of defense of states in Investor-state dispute settlement (ISDS). Firstly, the system of external firms hired by the state, and the political independence, time effectiveness and dedication that these firms would have with the cases, since they're not overwhelmed in the same manner as an in-house state counsel would be.

The second model comprised in-house attorneys to defend the state in arbitral

proceedings, since it would allow the scrutiny of the case and the better managing of various claims arising from the same measures. Nonetheless, the politically bound discourse could be a downside of this structure.

The third model would be one that combined the abovementioned.

Rodrigo Loustaunau, main legal counsel for arbitration of PEMEX, pointed out that the State should be concerned with developing virtuous cycle mechanisms, where the individual responsible for the termination of a contract with an investor make this situation known to the parties responsible for the initiation of the defense of the state in a possible investment arbitration. Additionally, he explained the private character of PEMEX contracts in relation to the Mexican Law and that, because of this, they might not have a clear path to investment arbitration.

Christian Carbajal, partner of Wöss & Partners, made a conceptual distinction between the late-1900's bilateral investment treaties (BITs), with a more liberal approach to investor protection, and the early-2000's free trade agreements (FTAs), with more lenient clauses to the state's regulatory powers.

However, he explained that this evolution does not mean that the state has an open mandate to regulate irrespectively of international law, since, even under the new FTAs, the measures shall consider the economic impact, the proportionality and reasonableness, the possible discrimination by the state and the interference with the investor's legitimate expectations.

He analyzed the restrictive measures taken by Mexico to recede from the 2013 energy reform, and the effect that these measures may have with respect to likely investment arbitrations soon. More specifically, a change from the classic scenarios of the public interest defense, such as in *Philip Morris v. Uruguay*, could arise, as investors could demonstrate to tribunals that not only they are complying with the legal requirements, but also that the measures taken by the Mexican State, when changing the regulations, were against public interests, which investors seek to preserve, as those related to renewable energy and environmental protection.

Challenges When Quantifying Damages in Energy Arbitration

Adriana San Román, founding partner of Wöss & Partners, discussed the valuation of newly established businesses and early-stage investments.

The conceptualization of an investment may have a value, provided that an idea may generate future profits with reasonable certainty. However, arbitral tribunals are often reluctant to award lost profits in case of early-stage investments as in *PSEG Global v. Turky*, *Metalclad v. Mexico*, and others; whereas, more favorable cases are found in *Ionnis Krdassopoulos v. Georgia* and *Abengoa v. Mexico*.

Furthermore, the main challenge to this kind of investments is the risk, which can be considered in the discounted cash flow (DCF) method, through a discount rate and the adjustment of expected cash flows, or through the comparable public company

approach and the comparable transaction approach. She recommended three techniques for a precise valuation of an early-stage investment: (a) scenario analysis, (b) the Monte Carlo simulation, explained in her Oxford University Press monograph on damages in international arbitration, and (c) real options, which may be used together with the DCF and market methods.

Non-operating natural resources investments are often different, since their mere existence may have a value, as it is the case with gold, minerals, oil and gas, provided all value-drivers are met (*Tethian v. Pakistan*, *Quiborax v. Bolivia*, *Gold Reserve v. Venezuela*, *Occidental v. Ecuador (II)*, *Rompetrol v. Romania* and *Crystallex v. Venezuela*).

Finally, the notion of loss of a chance does not serve to avoid the reasonable certainty requirement regarding the future income stream that was lost, since it is limited to luck, where lost profits are being awarded in proportion to the chance, but do not relieve from the burden of proof or lower the standard of proof.

Carla Chavich, of Compass Lexecon, initiated her presentation demonstrating that damages are the result of the actual scenario subtracted from the but-for scenario. When considering the energy sector, the key issues are the resources or the production capabilities, the output price forecast and volatility, the contractual and regulatory development and country risks.

Additionally, the investor´s expectations at the time of the investment must be determined and if the measure taken by the state generated uncertainty by changing the regulatory regime or the contractual framework; the main analysis is whether these measures had an impact on the value of the investment, the measure being the only relevant cause for the difference between the actual scenario and the but-for scenario.

Jennifer Vanderhart, from Intensity LLC, explained that the 2021 reform undid much of the benefit that investors would have seen if the 2013-2014 Constitutional Amends were to be maintained.

The 2021 reform changed the order of (electricity) dispatch so that the state-owned entities would be dispatched first; allowed existing contracts to be altered or cancelled; allowed issuing clean energy certificates to companies that had previously not qualified (Comisión Federal de Electricidad – CFE). Such measures will change the profits that investors can expect to earn from any recent investments.

In this scenario, damages can be calculated using a lost profits approach (especially if the asset has continued to operate), a valuation analysis, or a combination of both. A benchmark analysis may be possible, an analysis of planning documents may help determine what reasonable expectations were, and/or a simulation analysis may be performed to estimate “but-for” profits from an investment and compare to what has occurred. Any loss of value of clean energy certificates can also be examined, if the original timeline for adoption of low carbon emission power sources had remained the same, and the restrictions on the issuance of those certificates had remained the same.

Third-Party Funding

The panel on third-party funding (TPF) was conducted by the international arbitrator Francisco Victoria-Andreu, Marcel Wegmueller and Kirstin Dodge, the last two co-CEO and Director for the Americas of Nivalion AG in Switzerland, respectively. The panel discussed how TPF works in practice and the role of third-party funding in providing access to justice and making dispute settlement available through arbitration and litigation. Originally, only available to claimants who could not afford to pursue claims, TPF is increasingly being used to convert claims into assets.

Francisco Victoria-Andreu mentioned that we face and will continue to face economic distress which affects not only private investors but states and state-owned enterprises (SOEs), and that TPF, while often unknown to parties, plays a key role in providing access to justice in this scenario.

Marcel Wegmueller asserted that the funder is not a party to the dispute, nor has it control over parties' strategies. Parties could decide to use a funder even if they have the necessary resources available to finance the case, for risk transfer and liquidity reasons. He listed some characteristics parties expect their funder to have, such as the means to sustain a dispute for several years, a track record of stability, experience, understanding of litigation and arbitration proceedings and good communication between the funder with the legal team. Marcel asserted that Nivalion is open to funding both, claimants and defendants, at all stages of the proceeding, and that it focuses on corporate claims, being 40% arbitration and 60% litigation.

Kirstin Dodge provided an overview of the funder's working method, which includes an initial assessment of the claim and the parties, how it will be pursued, and estimated timing and budget. The commercial terms are proposed, which results in a term sheet being signed, which includes agreed pricing and an exclusivity period, during which Nivalion performs a detailed due diligence. At the end of the exclusivity period, if all goes well, the investment is approved and Nivalion begins to fund the proceedings.

The Honorable Charles N. Brower

The conference concluded with an interview of the Honourable Charles N. Brower, a world-renowned international jurist and arbitrator, by Dr. Devin Bray, of Wöss & Partners and his former private law clerk.

The topic of conversation focused on matters relevant to energy reform measures in investor-state cases. He calculated, amongst other things, that the degree of difference in legislative change are often more significant than the abruptness of change in legislation in any given case; that pursuit of prior or parallel proceedings to an international arbitration is a matter of case strategy; that experienced arbitrators may edge out inexperienced arbitrators in larger cases; that persuasive counsel must be able to explain their case in simple terms to the tribunal; that evidence, particularly

media articles, must be carefully weighed to ensure their credibility and reliability, and; that inconsistent awards and decisions may be regarded as a strength of a system of law, including investor-state dispute settlement, which Judge Brower highlighted when he quoted an essay written by Ralph Waldo Emerson: "A foolish consistency is the hobgoblin of little minds, adored by little statesmen and philosophers and divines."

Conclusions and Call for Articles

To conclude the Tenth Investment Arbitration Forum, Herfried Wöss thanked Judge Charles N. Brower for his presence as well as the panelists and the ample audience. Professor Guillermo Estrada Adán thanked the Instituto de Investigaciones Jurídicas of UNAM for all the support and announced that the recordings will be made available to the public at its conference webpage . He also made a call for articles in Spanish or English on the Second Mexican Energy Reform and Related Topics which will be compiled in a book, with the deadline on December 31, 2021.

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