Mexico’s Efforts to Undo the 2013 Energy Reform: Substantives and Procedural Protections for “Covered Investments” under the USMCA

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Since his inauguration in December 2018, Mexican President Andrés Manuel López Obrador (AMLO) has endeavored to reverse the liberalization of the energy market achieved by his predecessor. In the last few months, actions to resume government control of Mexico’s free energy markets have intensified with the adoption and proposal of regulation affecting investor’s rights and the value of projects. In consequence, dozens of constitutional protection lawsuits (“Amparo”)[fn]Amparo is an extraordinary constitutional appeal, which may be filed in federal court for several purposes such as a defense of the individual guarantees provided in the Constitution, and against unconstitutional laws.[/fn] have been filed against these measures and the Government has made itself target of potential claims in international fora. In this post, I will analyze the measures affecting both the power and hydrocarbons sector, as well as the local and international remedies available to affected investors.

Background

In 2013, Mexico adopted a constitutional reform (the "Reform") that liberalized the national energy industry. The Reform put an end to decades of State-run monopolies governing the petroleum and power industries, led by PEMEX (Petróleos Mexicanos) and the CFE (Comisión Federal de Electricidad), respectively. Through the Reform, Mexico opened its energy sector, allowing and incentivizing private (domestic and foreign) investment in all segments of the oil & gas industry, as well as in the generation and commercialization of electricity.

Given Mexico's prolific natural resources, the Reform boosted foreign direct investment (FDI). Indeed, following the Reform, Mexico has received over USD 32 billion in investments (see here and here), and expects to obtain at least USD 25 billion more in coming years.

Policy Shift: Changing the Rules of the Game

Since AMLO took office in late 2018, he has enacted a policy shift by resuming Government control of Mexico's energy industry, quoting sovereignty and national security concerns.

Petroleum sector

In the upstream realm, only a week into its term, the AMLO Administration ordered the suspension of pending exploration and production (E&P) licensing rounds and announced a revision of the legality of 107 E&P contracts awarded between 2015–2018 to private companies, such as Murphy Oil, Chevron, Fieldwood Energy, ExxonMobil and Talos Energy.

In the last few months, the government has also attempted to change the rules of the game applicable to the mid- and downstream sectors. In December 2020, the Ministry of Energy (SENER) issued the new Hydrocarbon and Fuel Import and Export Rules (the "Petroleum Import/Export Rules"), which sought to limit the ability of private companies to import and export fuel and hydrocarbons hence, strengthening PEMEX's market position. Specifically, the Rules establish a summary proceeding mechanism to revoke existing import/export permits and shorten the validity of new permits from 20 years to 5 years. The Rules also contain provisions potentially hindering applicants' opportunities to obtain new permits. Namely, the Rules: 1) require applicants to demonstrate that the export of hydrocarbons will not impact domestic supply in the mid and long term; 2) establish that applications are deemed rejected if SENER fails to issue a resolution within 12 business days; and 3) allow SENER to consult with State-owned companies, such as PEMEX, to determine the convenience of granting permits.

On top of the Rules, on May 4, 2021 the Mexican Government passed an amendment – sponsored by AMLO in March and approved by Congress in late April – to the Hydrocarbons Act, that modified certain key provisions. The amendment grants State-owned entities a greater role in the mid- and downstream sectors. Specifically, it grants the Government the power to suspend or revoke permits on vague grounds such as "national and energy security" or the "security of the national economy." Following the suspension of a permit, the amendment also allows the Government to occupy the corresponding facility and delegate their operation to State-owned entities, such as PEMEX.

<u>Power sector</u>

Before the Reform, Mexico had a traditional industry model where the CFE was responsible for developing all activities of the power industrial chain. The Reform created a free power market, and sought to incentivize private investment in power generation. Some of the incentives included: 1) priority access to the grid for the most cost-efficient generators, usually wind and solar energy generators; 2) allowing renewable energy plants built from 2014 onwards to obtain and sell Clean Energy Certificates (CEL), that companies in Mexico can use to meet local renewable energy requirements; and 3) requiring the CFE to purchase electricity by auction to get the cheapest offer available.

In early March 2021, Congress passed a bill amending Mexico's Electricity Industry Law (the "Electricity Bill"). Similar to the measures mentioned above, the Electricity Bill aims to resume State control of the national power market.

The Electricity Bill reversed all the aforementioned incentives. Specifically, this amendment 1) grants grid priority access to CFE plants, regardless of their cost or environmental efficiency; 2) allows CFE pants to obtain CELs, regardless of their age; and 3) eliminates the obligation of the CFE to purchase electricity by auction, which in practical terms allows the CFE to buy it from its own plants instead of from cheaper power private plants. The Electricity Bill also mandates the CFE to revise and, if applicable, terminate any long-term purchase contracts with private generators and grants the Energy Regulatory Commission (CRE) broad power to revoke self-supply permits.

Challenges before Domestic Courts

The measures mentioned above impact Mexico's energy sector profoundly, and have the potential to affect several investments made in reliance on the Reform. Hence, it is not surprising that dozens of companies have already challenged the constitutionality of those measures by filing Amparos before local courts.

In late February 2021, a federal judge ordered the suspension of the Petroleum Import/Export Rules, concluding that they violate the constitutional right of free competition and favored PEMEX over other market actors. Likewise, the amendment to the Hydrocarbons Act was also suspended on constitutional grounds, barely a week after its adoption.

In regard to the Electricity Bill, over 30 Amparos have been filed challenging its constitutionality, specifically alleging that it violates several constitutional rights, e.g., free competition, the competitiveness of the power sector, and environmental protection. In consequence, in mid-March, a federal judge granted an injunction halting the effects of the Electricity Bill for every potentially affected company, until a final decision is reached by a federal court. All suspensions are temporary, pending a final decision of the local courts.

In the face of a potentially long judicial battle, the AMLO Administration is considering a constitutional amendment of the energy sector, aimed at removing any grounds for challenges to its attempts to dismantle the Reform. The constitutional amendment could take place after June's midterm elections, provided that AMLO's party – Morena – obtains the two-thirds super majority needed to change the constitution.

Remedies through International Arbitration

Mexico has signed and ratified – at least – thirty-six bilateral investment treaties (BITs), the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), and the United States-Mexico-Canada Agreement (USMCA). These treaties subject Mexico to a number of commitments in favor of international investors, for example, allowing the latter to bring arbitration claims against the former. Mexico is also party to the ICSID Convention.

The changes to Mexico's power and petroleum sector might be deemed a violation of some investment protections established in the aforementioned treaties. For example, Mexico might be found to be expropriating investments (directly or indirectly), taking arbitrary and discriminatory measures and/or failing to provide international investors with fair and equitable treatment (FET).

While each of these instruments offers unique procedural avenues and legal protections, it is worth noting that FDI flowing to Mexico comes – disproportionately – from the United States. As such, this section focuses on potential claims arising out of the USMCA.

For disputes brought against either the US or Mexico[fn]Canada is not included in the investor-State dispute settlement mechanism of the USMCA. The CPTPP, however, does provide for ISDS for Canadians and Mexicans investing in Mexico and Canada respectively (see here and here).[/fn], the USMCA provides for two distinct dispute resolution frameworks which apply based on the type of investor. Specifically, covered investments – which include highly regulated activities, such as oil and gas and power generation projects – are afforded certain benefits that other investments are not.

First, covered investors have more grounds under which they can bring arbitration claims. Generally, USMCA only allows claims for direct expropriation, and breach of the national treatment and most favored nation principles. Covered investors can bring claims on additional grounds, including indirect expropriation and failure to provide FET, which usually includes a prohibition for states to act in an arbitrary or discriminatory fashion.

It is important to highlight that the USMCA limits the scope of FET and establishes that it only includes the obligation not to deny justice and to act in accordance with due process. It also excludes any action or omission that is inconsistent with investors' legitimate expectations. This is relevant because the concept of legitimate expectations might be central for investors to assert that the AMLO's reforms breach Mexico's FET obligations. As previously reported on the Blog here and here, investors' legitimate expectations were the central issue of 28 recent arbitrations brought against Spain, Italy and the Czech Republic for an issue somewhat similar – but also different in various aspects – to Mexico's Electricity Bill, i.e., the removal of incentives to attract investments in renewable energy. Granted, some tribunals concluded that the existence of legitimate expectations is not necessary for a violation of FET to exist, but this seems to be so in only a handful of cases.[fn]See, e.g., Tecmed v. Mexico, ICSID Case No ARB (AF)/00/2, Award 29 May 2003.[/fn]

Second, the USMCA has an asymmetrical fork-in-the-road clause that states that US investors "may not submit to arbitration a claim that Mexico has breached an obligation under this [Treaty] . . . if the investor or the enterprise, respectively, has alleged that breach of an obligation under this [Treaty] in proceedings before a court or administrative tribunal of Mexico." This clause should not prevent companies that filed Amparos from initiating arbitration proceedings under USMCA for at least two reasons. On the one hand, the Amparos were based on breach of Mexico's constitution, not the USMCA. On the other, the fork-in-the-road clause does not apply to previous actions seeking injunctive relief, not monetary compensation.

Third, the USMCA states that investors must first obtain a final decision from the local courts of final appeal or defend their claims in local courts for 30 months before initiating arbitration, unless such action would be "obviously futile". This period of time runs concurrently with a four-year statute of limitations for asserting any claim through investment arbitration. Claims arising from covered investments, however, are exempted from this limitation and can be brought directly before an arbitration tribunal.

Fourth, it is important to remember that, although, the USMCA allows the submission of some legacy claims under Chapter 11 of the North American Free Trade Agreement (NAFTA), this prerogative is not extended to covered investments. This is relevant because NAFTA did not have the restrictions mentioned before, i.e., the limited scope of FET.

Finally, investor claims could also be based, not on treaties, but on commercial contracts between them and Mexican Government entities. Mexico's model contract for E&P activities, for example, allows investors to submit claims to arbitration with seat in The Hague, under UNCITRAL Rules. By the same token, local regulation allows private generators dispatching power to the grid to agree to arbitration in Mexico, under the ICDR Rules.

Conclusion

The attempted reforms to the petroleum and power sectors would certainly impact the economics of private projects deeply. It could be months until federal courts reach a final decision on the constitutionality of these measures. The Administration's plan to amend Mexico's constitutions add even more uncertainty to the energy sector. At this stage, companies would be well advised to start studying avenues other than Amparos to resist or mitigate Government action. The USMCA, as well as other dozens of investment treaties ratified by Mexico, provides them the substantive and procedural means to achieve it. In the case of investors starting or planning to start Amparos, who are also eligible to bring claims under the USMCA, it is important to define the scope of the former, in a way that does not impede their future ability to present the latter.