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The Mexican Energy Counter-Reform – Impact and the Illegality Threshold (Tenth Investment Arbitration Forum: Part I)

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" or energy counter-reform and the impact of the multiple regulatory and legal changes by the Mexican government on energy investments and different investment arbitration scenarios.

The Impact of the New Energy Reform: Clean Energy Certificates, Renewable Energy, Electric Industry, Oil & Gas

The panel discussed the impact of Mexico's second energy reform and the future of energy in Mexico.

Carlos Francisco Rodriguez Sámano of Wöss & Partners and Ángel Lárraga, a former CEO of a large energy company in Mexico and senior consultant, explained the measures implemented by the Mexican government since 2018 to reverse the energy reform of 2013, aiming at converting the electricity state owned company CFE and the national oil company PEMEX again in monopolies, at the expense of private businesses, mainly related to renewable energies and private energy generation.

This has led to massive constitutional injunctions or amparos and the suspension of state measures while constitutional procedures are pending, as well as the declaration by the Supreme Court of the unconstitutionality of the measures regulating the energy sector by CENACE (electricity regulatory agency) and the Ministry of Energy.

The overview was followed by a debate in which Veronica Irastorza, a former Deputy Secretary of the Ministry of Energy and senior consultant of Nera Economic Consulting, pointed out that the reform does not change the foundations upon which the energy policy in Mexico is based.

Furthermore, as the world is moving towards renewable energy, this goal will be better achieved

through public and private partnerships, with investments coming from both CFE and private investors. Moreover, there are viable models involving higher and lower levels of public ownership, and tariff regulation should be clear, with a transition period so that investors can make informed decisions.

Casiopea Ramírez of Fresh Energy, underlined that those sanitary restrictions imposed on power plants due to Covid-19 and their impact on supply have proven the importance of the energy generation to the country, and the difficulties in meeting consumer demand. Furthermore, tariff regulation is to ensure uninterrupted access to electricity at reasonable cost, which is currently achieved through subsidies designed to keep tariffs below inflation. She concluded that there is an imminent risk of a tariff deficit which could compromise supply, and that penalizing renewable energy instead of fomenting such energy is counterproductive to the goal of moving towards sustainable energy.

The Paris Convention and Climate Change Arbitration

This panel discussed disputes between states concerning climate change.

Judge Tullio Treves, former judge of the International Tribunal of the Law of the Sea, addressed the three main international treaties on climate change: The Vienna Convention for the Protection of the Ozone Layer, the Kyoto Protocol and the Paris Convention; and asserted that the dispute resolution mechanisms in these treaties are relatively inefficient.

He pointed out that only 2 out of 177 signatories to the Vienna Convention have made a declaration allowing other signatory states to initiate proceedings before the ICJ or an arbitral tribunal in case a dispute emerges. He also observed conciliation proceedings are similar to an arbitration proceeding, in that witnesses are heard, and documents analyzed, citing *Australia v. Timor Leste*, as an example of a successful proceeding.

Professor Guillermo Estrada Adán, of the Instituto de Investigaciones Jurídicas and faculty of law at UNAM (Universidad Nacional Autónoma de México), presented an overview of existing and potential international disputes regarding energy regulation and policy.

Disputes may arise from actions by companies and affected persons, state regulatory measures regarding climate change, insufficient state actions under international obligations, revoked permissions which lead to disputes concerning renewable energy investments, performance of contracts, and, finally, specific CO_2 emissions levels under the Paris Convention. The *fori* include national courts, regional human rights protection systems, the Court of Justice of the European Union (CJEU), the International Court of Justice (ICJ), investment arbitration and inter-state arbitration. He pointed out that, despite the existence of specialized treaties and regulatory systems, a specialized jurisdictional forum for the settlement of climate disputes still has not been created.

Nonetheless, global solidarity is necessary to align technology to ethics in preserving the right of future generations.

Investment Arbitration and the Energy Sector

Professor Loukas Mistelis, Professor of Transnational Commercial Law and Arbitration of Queen Mary, University of London, addressed the role of international investment arbitration in dispute resolution within the energy sector.

The current political debate takes into consideration the need to make sustainable and renewable energy available, and that international investment arbitration allows foreign investors with the capital and expertise to have legal security to invest in areas where natural resources are abundant.

Considering the differences between commercial and investment energy disputes and the differences between clean energy and renewable energy – in that clean energy sources mean none or significantly limited carbon emissions and renewable energy means it stems from permanently renewable sources – Prof. Mistelis pointed out the role of investment tribunals in determining whether regulatory measures taken by states contradict commitments made by the state in the international sphere.

Regarding international investment disputes, 20% of the cases administered by the International Chamber of Commerce (ICC) are energy disputes and 30% of the

International Centre for Settlement of Investment Disputes (ICSID) Cases as well. He observed that energy reforms, such as the second energy reform in Mexico, are seen as a likely trigger of disputes.

Regulatory Freedom and the Illegality Threshold

This panel discussed the regulatory power of the state and the threshold between legitimate exercise of this power and violation of the rights of investors.

Gaela Gehring Flores, of Arnold & Porter, provided a complete overview of the United States–Mexico–Canada Agreement (USMCA) and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), the remedies available to investors and the new generation of treaties based on the 2012 US Model BIT, going through all the standards of investment protection available. She also analyzed the most crucial jurisdictional issues, such as fork-in-the-road provisions, waivers, limitations periods, dual nationality of investors, environment and public welfare.

Professor Carlos Humberto Reyes Díaz, of the Instituto de Investigaciones Jurídicas at UNAM, asserted that investors are not in a position to expect that regulation will not be altered throughout the duration of their investment. He cited various passages of the initiative of the reform of the Federal Electricity Industry Law, referring to corrupt politicians and lucrative business of private enterprises, which mark the tone of the second energy reform and underline a rejection to private investment in the energy sector. The relevant questions emerge such as whether legitimate expectations have been generated by written commitments from the state.

Francisco Rivero, of ReedSmith, mentioned that distinguishing between a sovereign's legitimate exercise of its regulatory freedom and regulation that crosses the illegality threshold is neither theoretically simple nor practically predictable. The meteoric rise of the renewable energy sector – accompanied by subsidies, credits, and governmental support aimed at encouraging investment –has raised key questions regarding the need for investment protection versus a host

nation's right to govern.

One way to assess whether an investor has received fair and equitable treatment involves the analysis of legitimate expectations existing at the time of its investment. Whereas some tribunals have found that legitimate expectations could arise from the very contents of general laws and regulations, others have applied more restrictive tests, requiring specific representations and commitments from a host government to the investor.

While it is reasonable for investors to expect that the constitutional and legal framework pursuant to which they invested will remain stable, that is not to say that the legal framework at the time of investment is immutable. Although not without its detractors, a recent line of cases has developed an *effects* analysis that considers an investors' expectations of a "reasonable return on investment" to assess whether regulatory measures cross the illegality threshold.

Herfried Wöss, founding partner of Wöss & Partners, provided an overview of the formulation of the fair and equitable treatment standard under the main investment agreements signed by Mexico and recent legislation efforts of the standard, as well as leading cases. The key issue for an arbitral tribunal is to define the so-called illegality threshold which separates legitimate regulatory measures from illegal state acts, as shown in *Eiser v. Spain*, *Novaenergía II v. Spain*, *Antin v. Spain* and *AES v. Hungary*. The illegality threshold is a key element for the quantification of damages under the but-for premise or differential hypothesis established in the *Factory at Chorzów*, as damages are a mirror-image of the liability case.

The threshold has two axes, one refers to the time-aspects of the measure, and the other, to the intensity of the measure. Economic effects of the measure outside the timeframe established by the arbitral tribunal and below the intensity threshold, are not to be taken into consideration. Legitimate expectations duly recognized play a role in this respect. This is shown, amongst others, in *Murphy v. Ecuador*, in which a 99% tax on hydrocarbons applied by the State, was considered above the threshold of legal regulatory discretion and in violation of the investor's legitimate expectations, but the 50% percent tax was considered within the regulatory limits of the state. Damages were awarded based on the difference between the legal 50% tax and the illegal 99% tax.

Amparos and Fork-In-The-Road

Lauren Mandell, of WilmerHale, examined the "fork-in-the-road" mechanisms in the USMCA/NAFTA and CPTPP investment chapters, which are not classic fork-in-the-road mechanisms that require choosing either domestic litigation or investor-state dispute settlement (ISDS), with one choice foreclosing another. Rather, Mr. Mandell explained that investors may litigate in domestic courts without relinquishing access to ISDS, provided that if they initiate ISDS, they generally may not maintain or initiate domestic litigation regarding the same measure (i.e. "no U-turn"). Nonetheless, Mr. Mandell warned investors not to discuss in domestic courts matters that could be argued before an arbitral tribunal, since Mexico has specific reservations that preclude such action.

Investors can continue to bring claims under NAFTA, until July 1, 2023, for state measures taken until 30 June 2020, while NAFTA was still in force.

Dr. Nikos Lavranos, of Wöss & Partners and Secretary-General of the European Federation for

Investment Law and Arbitration (EFILA), compared the BITs that Mexico has ratified with the Netherlands and Spain, as well as the recent EU-Mexico Global Agreement, demonstrating differences in procedural and substantive law. Taking into consideration that the first significant measures in Mexico date back to 2019, he mentioned that investors must be aware of the time limitations for bringing international arbitration claims of 3 to 4 years. Investment arbitrations might be triggered through a rather short submission followed by a six-month cool-off period, which should be used for finding amicable solutions. This period might be dedicated to mediation using, for example, the services of the Energy Community, an international organization based in Vienna.

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