# Foro de Arbitraje en Materia de Inversión – Investment Arbitration Forum

## Seventh Investment Arbitration Forum: The Mexican Energy Reform

The Seventh International Investment Arbitration Forum took place on July, 2015 at the Tecnológico de Monterrey (Santa Fé Campus), a leading Mexican private university, and was organized by the Mexican Arbitration Center ("CAM" for its Spanish acronym) and Wöss & Partners.

Dr. Herfried Wöss made the opening remarks providing an overview of the key issues of the energy reform such as the changes resulting from the creation of state production companies, the non-arbitrability of the administrative rescission, the question of the proper venue for domestic litigation of administrative rescission and acts of authority, changes with respect to arbitration clauses and places of arbitration, recent developments in international arbitration, the question whether an administrative rescission in conformity with an oil production contract may constitute an expropriation, and the importance of the proper framing of damages claims in investment arbitration.

The initial panel was formed by Dr. Alejandro Posadas Urtusuástegi of the Tecnológico de Monterrey, David Shields, expert in the oil and gas sector and general editor of the journal 'Energía a Debate', and practitioners Oscar Cruz Barney and Javier Zenteno Barrios, a former general counsel of PEMEX. The panelists focused on the transition from the monopoly-based policy to the participation of private investors in the oil and gas sector, which has a significant effect on public tenders, contract models and the oil and gas business in general.

Mr. Shields argued that despite the reform, a political environment could still permeate Pemex and CFE whilst Mr. Zenteno argued that the reform will allow the companies to remain competitive. Dr. Posadas mentioned that it will be interesting to see how the State differentiates between being an owner and being a services provider under the new regime. The fact that the contracting process still requires a public bidding process in contrast to other countries raises doubts among practitioners given that the ability to negotiate is still not absolute and is subject to a screening process.

The second panel turned its attention to the *Commisa v. Pemex (PEP)* case. The panel focused on Commisa´s unfortunate constitutional lawsuit, which converted the administrative rescission from an act *de iure gestionis* to an act *de iure imperii*, which lead to its non-arbitrability. It further examined notions of arbitrability and public order. The panel recognized that based on fairness and the *Chromalloy case,* the Courts in the United States granted recognition despite annulment by Mexican courts. Currently the process is still ongoing. The limitations of arbitrability in the public works and acquisition and the public-private partnership laws seems to have been provoked by the Commisa parallel litigation leading to the judgment of the Second Chamber of the Mexican Supreme Court in 2006 which clearly established the non-arbitrability of acts of authority and the administrative rescission which influenced the 2009 reforms of the public works and acquisition laws. Instead of retroactive application of the law as mentioned by the District Judge Hellerstein in New York, the Commisa constitutional litigation provoked the non-arbitrability issue which lead to its annulment in Mexico.

The next panel led by Dr. Francisco Alberto Ibarra Palafox of the Instituto de Investigaciones Jurídicas of Mexico's largest public university, UNAM, and the principal attorney of the Federal Electricity Commission, Ricardo Izeta Gutiérrez, and Sergio Rodríguez Labastida of the Chartered Institute of Arbitrators, expressed their concerns with respect to the limit on arbitrability under the new Mexican Hydrocarbons Law. The fact that administrative rescission is not a matter for arbitration with the National Hidrocarbons Commission ("CNH") represents political risk affecting the cost of projects. The issues raises a series of questions such as whether contractual liability could still be determined through arbitration, whether a stay of the judicial procedure might be requested until contractual liability has been decided by an arbitral tribunal, and what was the venue for litigation in the light of commercial law applicable to project agreements. Those are just a few matters that will be left for practitioners to argue should a future dispute arise. The hybrid nature of commercial project agreements and administrative rescission deriving from the French notion of the 'contrat administratif' will inevitable cause conflicts.

The third panel was composed by arbitration experts Luis Omar Guerrero Rodríguez of Hogan Lovells and Eduardo Magallón Gómez, an investment arbitrator, moderated by Myriam Rosales Jiménez. The topic centered on the new arbitration clauses applied by the National Hydrocarbons Commission (CNH), Pemex and CFE. Interestingly, the CNH demands for an ad-hoc arbitration under the UNCITRAL Rules with the seat of arbitration in The Hague applying substantive Mexican Federal law and having the president of the International Court of Justice appoint the arbitral institutions in charge of the procedure. Mr. Omar Guerrero spoke about the benefits that an arbitral institution be chosen from the outset of the arbitration. The fact that the President of the International Court of Justice ("ICJ") is the appointing authority raised concerns in the panel. The formal request to the ICJ could generate complications on the process; perhaps the Secretary-General of the Permanent Court of Arbitration could have made more sense given that it is the default authority under the UNCITRAL rules. Still the delay caused by a nominating institution instead of using administered arbitration will increase the cost of arbitration.

The CFE and Pemex arbitration clauses call for arbitration under Mexican Federal Law, with their seat of arbitration in Mexico under the rules of the London Court of International Arbitration. The panel reminded the audience that LCIA demands a pay per hour rate in contrast with other institutions. However, if true independence and transparency were to be afforded to investors then perhaps a neutral seat should have been chosen. The new PEMEX and CFE laws allow for arbitration abroad.

The fourth panel spoke about liabilities, political risks and main energy arbitrations in Latin America moderated by Tom Allan Cunningham, an experienced oil and gas attorney from Houston. Arbitration expert Ms. Elisabeth Eljuri of Norton Rose Fulbright reminded the audience about obsolescing bargain – when governments no longer get their fair share - and the advantages of preventing this with a stable legal and fiscal regime by creating an alignment between State´s and Investor´s incentives. Ms. Eljuri also referred to the *lex petroleum* encompassing national petroleum laws, contracts, customs and practice in the industry and arbitral awards. Mr. Eloy Barbará of Curtis, Mallet-Prevost, Colt & Mosle reminded the audience about *Occidental v. Ecuador, Exxon v. Venezuela and Yukos v. Russia*, the largest award on liability ever being rendered in investment arbitration to be further analysed in the TDM Special on Yukos.

The fifth panel discussed the challenging topic of administrative rescission without indemnity. Chaired by Dr. Herfried Wöss, and former and actual government lead counsels Mr. Hugo Perezcano and Carlos Vejar, as well as Héctor Anaya Mondragón of Creel, García-Cuéllar, Aiza y Enriquez, the panel´s main concern was investor´s protection under the new regime. Messrs. Perezcano and Vejar argued that although administrative rescission was for the public entities to decide, the law established clear scenarios under which this measure would arise. This means rescission is unmistakably attached to breach of the contractual conditions and the investor is allowed to remedy such breach. Moreover, the law refers to a final set of accounts ("finiquito") so the Mr. Vejar noted that acting in accordance with internal law does not imply a violation of international rules.

However, Mr. Anaya pointed out that acting in accordance with State rules does not necessarily mean that international rules are being complied with, quoting passages from *Gold Reserve v. Venezuela* on which the State rescinded a contract but was eventually held accountable, whilst also reminding the audience that government´s final set of accounts usually entail long and burdensome protocols and are not necessarily fair to the investor.

Whilst Dr. Wöss mentioned that the benchmark seems to be expropriation subject to the payment of fair compensation in case the State obtains a significant benefit from administrative rescission, for example, when oil has already been found and substantial sunk investment has been made which is transferred to the State. Messrs Vejar and Perezcano argued that not every economic affectation constitutes expropriation or creeping expropriation. The Vigotop v. Hungary case was mentioned with respect to the question whether a contractually legal administrative rescission could amount to illegal expropriation without the panelists being able to agree on a specific benchmark. Dr. Wöss remarked that the distinctive element between a mere contract and an investment in form of a contract was whether it was an income-generating asset or investment as already observed in the *Factory at Chórzow* case.

The final panel dealt with the framing of damages claims in oil and gas projects as exposed by Dr. Wöss and Ms. Adriana San Román Rivera, authors of the leading monograph on damages in international arbitration (OUP 2014). Dr. Wöss started with a short review of the origins of modern damages law based on Aristotelian ethics, Thomas de Aquino's Summa Theológica and 19th century German scholarship, which culminated in the famous Factory at Chorzów case. He stated that there is a palpable difference between damages arising out of bilateral legal relationships and the effect of international tort on income generating asset or investments where the "*synallagmatic triallagma"* with income generated from a third party, the market, mandates a different structure of damages analysis.

He argued that international customary law and economic theory indicates that the valuation should rather be at the time the award. He further observed that in case of legal expropriation, the measure of damages is often the fair market value at the moment of the expropriation, whereas in case of illegal expropriation and following customary international law as found in the *Factory at Chorzow* case, it is also fair market value, but at the moment of the award, whereby the compensation for legal expropriation is the benchmark and minimum value. He mentioned the *Yukos* case, which is a prominent example of the application of the *Factory at Chorzów* case albeit not using the income stream but a stock exchange index as the relevant factor to adjust the value, as commented in a recent article forming part of the TDM Special on Yukos.

Ms. San Román explained that even though the parameters could seem pro-investor, the expectation interest or but-for income stream must be reasonably certain. In other words, the reconstruction of the hypothetical course of events, including the determination of each contingency, has to be based on evidence. As an example of this she cited the *Bridas v. Turkmenistan* case.

In the *Bridas* case, the investor first sought a desirable outcome and then searched for elements to satisfy the evidentiary burden. In this case the price was not relevant since there was no reasonable possibility of accessing the market. Overall the lesson is: reach for reasonable certainty on the existence of income stream and the effect of the violation on the same. This way there will be no over or under compensation. She also mentioned, that the burden of proof for the reliance interest may shift according to the applicable law. For instance in English and German law the defendant must prove that the initial investments were not recoverable. With respect to updating past income, the weighted average cost of capital (WACC) is ideal and essentially gives a average operation cost and allows the investor to recoup at a fair value, no more and no less.

Participants at the Seventh Investment Arbitration Forum came from leading government institutions, corporations and practitioners involved in the oil and gas business and arbitration experts, which lead to interesting discussions. As a conclusion, there is an awareness of certain key issues that have to be resolved in order to reduce political risk in future energy projects in Mexico.

The Investment Arbitration Forum is planning to publish its third book on that topic and the call for articles will be published soon.

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