Investment Protection and Mexican Energy Reform

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Introduction

Modern arbitration in Mexico commenced with reforms to the Mexican Commercial Code in 1989 and the adoption of the United Nations Commission on International Trade Law (UNCITRAL) Model Law on International Commercial Arbitration in 1993. Project agreements with state entities such as Petróleos Mexicanos (Pemex) and the Federal Electricity Commission (CFE) have been submitted to arbitration since 1993. In 2009, under the Federal Law for Public Works and Services (the 'Public Works Law') and the Federal Law for Acquisitions, Leases and Services of the Public Sector (the 'Public Acquisition Law'), arbitration was made available for all federal government procurement contracts, with the exception of administrative rescission and termination of contracts and project agreements. As of 16 January 2012, the Public–Private Partnerships Law (the 'PPP Law') extends non-arbitrability to any act of authority by a public entity.[1]

The limitations placed on arbitrability in the Public Works Law, Public Acquisition Law and PPP Law were tested by *Commisa v Pemex* ('*Commisa*').[2]

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1 Herfried Wöss, 'Arbitration under the Mexican Energy Reform: the lessons of Pemex v Commisa' Kluwer Arbitration Blog, November 2014, http://kluwerarbitrationblog.com/2014/11/07/arbitration-under-the-mexican-energy-reform-the-lessons-of-commisa-v-pemex accessed 5 March 2018; Herfried Wöss, 'El Arbitraje y la Reforma Energética' Energía a Debate (January 2015) http://energiaadebate.com/el-arbitraje-y-la-reforma-energetica accessed 5 March 2018.

2 ICC Case No. 13613/JRF.

In this case, the claimant pursued constitutional litigation (an *amparo* action) parallel to the arbitration in order to have the administrative rescission of the project agreement by Pemex declared as an act of authority – which is a requirement of admissibility in any *amparo* action – and to have such an act annulled because of purported violations of the Mexican Federal Constitution. The case ended up in the Second Chamber of the Mexican National Supreme Court (SCJN), which recognised in 2006 that the administrative rescission that had previously been considered *de iure gestionis*, was an act of authority *de iure imperii*. The $300m arbitral award granted in Mexico was annulled in Mexico, but has been recognised by the Southern District Court of New York due to the alleged retroactive non-arbitrability of the 2009 reform. This seems to be flawed; as such, non-arbitrability is the consequence of the *Commisa amparo* (*habeas corpus*) and the Supreme Court judgment of 2006.[3]

Commisa is an example of the problematic use of the French law institution of the *contrat administratif* (public law administrative contract) as used in Mexico and various Latin American, Northern African and other countries that adopted the French legal system. Whereas in France the *exorbitant power* for unilateral contract termination, or events distorting the contractual balance, triggers indemnification obligations of the state or state entity, in Mexico, such indemnification obligations are very rudimentary or non-existent and are limited to the compensation of 'non-recoverable expenses', which is, in fact, paradoxical. Combined with the non-arbitrability of acts taken by the state, this creates a considerable political risk, which is likely to provoke investment arbitrations.

Through the secondary laws adopted as of 11 August 2014, the Mexican energy reform marked a radical change, abandoning the institution of the administrative contract and administrative rescission in favour of project agreements based on commercial law and party autonomy as regards Pemex and CFE, where the term of administrative rescission is not even mentioned. In the case of contracts to be entered with the National Hydrocarbons Commission (Comisión Nacional de Energía (CNH)), administrative rescission remains an act of authority of contractual termination. The paradox regarding hydrocarbon contracts is that the possibility of administrative rescission remains in a contract that follows a mercantile regime. The same situation can be found in the public–private partnerships governed by the PPP Law of 2012. Both types of contracts can be considered 'hybrid contracts',

3 Jennifer Cabrera, Dante Figueroa and Herfried Wöss, 'The administrative contract, non-arbitrability, and the recognition and execution of awards annulled in the country of origin: the case of Commisa v Pemex' (2016) 32(1) Arbitration International 125, http://arbitration.oxfordjournals.org/content/early/2015/09/25/arbint.aiv057 accessed 5 March 2018.

that is, mercantile contracts with elements of administrative contracts, as opposed to purely administrative contracts under the Public Works Law or Acquisitions Law, or purely mercantile contracts under the new Pemex and CFE laws. Additionally, the Hydrocarbon Law prohibits compensation in the case of an administrative rescission, which is questionable under international investment protection law.

In this article, we address the role and potential impact that administrative rescission has on private–public projects under the Mexican legal system and with specific regard to its recently revised Hydrocarbon Law. First, a project's political risk vis-à-vis instance of non-arbitrability of administrative rescission and prohibition to pay compensation under the Mexican Hydrocarbon Law is outlined. Next, a state's responsibility under international law, specifically in light of investment treaty standards of protection, is explored as an alternative course of action. In the final section, we conclude by acknowledging the precarious position in which private–public projects are placed under the Mexican Hydrocarbon Law, as well as the challenges associated with entrenching an exhaustion rule to pursue local remedies in advance of international dispute resolution in national legislation.

Political risk through non-arbitrability of the administrative rescission and the prohibition to pay compensation

'Hybrid' oil and gas exploration and production contracts

Oil and gas exploration and production contracts with the National Hydrocarbons Commission are governed by commercial law and subject to the imperative provisions contained in the Hydrocarbon Law, as expressly established in Article 22 of the Hydrocarbon Law. This is confirmed in Article 97 of the new Hydrocarbon Law, which expressly confirms that the acts of the hydrocarbon industry are considered to be mercantile, providing for the application of the Mexican Commercial and Federal Civil Codes.

The administrative rescission as an act of authority

Contracts with the National Hydrocarbons Commission under the Hydrocarbon Law relate to natural resources such as oil and gas that are the property of the nation. Despite their mercantile character, Article 19, section VIII, of the Hydrocarbon Law clearly establishes that provisions for administrative rescission and termination have to be included in hydrocarbon exploration and production contracts. The causes for administrative rescission are expressly regulated in Article 20 of the

new Hydrocarbon Law and refer to the gross non-performance of the contractor, such as a failure to initiate or the unjustified suspension of works. The following paragraph of Article 20 establishes the procedure for administrative rescission.

The non-arbitrability of administrative rescission

Article 21 of the new Hydrocarbon Law provides for arbitration of oil and gas exploration and production contracts subject to the Mexican Commercial Code as *lex arbitri*. Administrative rescission and termination, however, is expressly excluded from arbitration as a matter of non-arbitrability *ratione materiae*.

Regarding dispute settlement, Article 21 of the Hydrocarbon Law provides that:

> 'Regarding disputes under Contracts for Exploration and Production, with the exception of those mentioned in the foregoing article, those contracts may provide for alternative dispute resolution, including arbitration under the terms of Title Four of Book Five of the Mexican Commercial Code and international treaties in the matter of arbitration and dispute resolution of which Mexico is a party'.

The second paragraph of Article 21 of the Hydrocarbon Law states the National Hydrocarbons Commission and affiliated contractors may not apply foreign law. The arbitral procedures established in this paragraph are subject to the following:

- the applicable law is federal Mexican law;
- the language of arbitration is Spanish; and
- the award is based on law and shall be obligatory and binding for both parties.

The reference to foreign law in Article 21 of the Hydrocarbon Law apparently refers to the governing law of the Contract. Article 22 of the Hydrocarbon Law establishes that the Hydrocarbon Law and its regulations, which are supplemented by mercantile law and federal civil law, govern contracts for exploration and production. The place of arbitration is left open and may be abroad. The reference to Title Four of Book Five of the Mexican Commercial Code in the first paragraph of Article 21, referring to the rules applicable to the arbitral procedure or *lex arbitri,* is optative ('may provide for alternative dispute resolution, including arbitration under ...').

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ratione materiae. This means that according to the judgment of the Second Chamber of the Mexican Supreme Court in 2006, administrative rescission and termination would have to be litigated before Mexican federal courts in administrative matters. These courts are quite competent in tax matters, water, and perhaps also competition and intellectual property law, but are ill equipped to hear cases on complex infrastructure projects.

Undoubtedly, the opting out of arbitration by the National Hydrocarbon Commission through administrative rescission increases its financial costs and the political risk of hydrocarbon projects. Administrative litigation in a complex contract case is likely to take ten years, as evidenced by cases resolved by district courts in administrative matters, as is notoriously known in Mexico.

Arbitration and Round 1 of Mexican hydrocarbons tenders

The contract for the fourth public tender of Round 1 of the Mexican hydrocarbons tenders after the energy reform (Round 1 Contract),[4] dated 16 May 2016, contains a series of safeguards to reduce the political risk of an administrative rescission.

Clause 26.2 (Conciliation) of the Round 1 Contract provides for optional conciliation under the UNCITRAL Conciliation Rules. However, the conciliation procedure does not apply in to administrative rescission under the contract and applicable law. According to paragraph 4 of Clause 23.2 (Prior Investigation), the parties have to appoint an independent expert in order to determine whether the contractor has violated its obligations under the contract, which could give rise to administrative rescission under Clause 23.1 (Administrative Rescission). During the prior investigation, the independent expert and contractor may prepare reports with respect to the possible grounds for administrative rescission. These reports must be rendered within the time limit agreed between the parties. According to Clause 26.3 (Qualities of the Conciliator or Independent Expert), the independent expert has to show at least five years of experience in matters related to administrative rescission. This highlights that the opinion of the independent expert is not binding on the parties or any governmental authority.[5]

The exclusive venue for administrative rescission under Clause 26.4 (Federal Tribunals) is before Mexican federal tribunals. However, in the case where the federal tribunals declare the grounds for administrative rescission were not met, the contractor may pursue a damages action

4 Bidding Guidelines CNH-R01-L04/2015.

5 'The opinions of the expert will not be binding on the Parties or any Governmental Entity'.

before the arbitral tribunal established under Clause 26.5 (Arbitration) with respect to damages caused by the unfounded administrative rescission and the extent of those damages.

Any other dispute not relating to administrative rescission that has not been resolved through conciliation, as applicable, may be submitted to arbitration in conformity with Clause 26.5 (Arbitration), subject to ad hoc arbitration under the UNCITRAL Rules of Arbitration and with the Secretary General of the Permanent Court of Arbitration as the nominating authority. Each party has to nominate its arbitrator, and the president will be appointed in the manner provided for under the UNCITRAL Rules of Arbitration. The language of arbitration is Spanish. The applicable law is Mexican Federal law as established in Clause 26.1 (Applicable Law) and the place of arbitration is The Hague in the Netherlands. Each of the parties has to bear its own cost.

According to Clause 26.7 (Non-Suspension of Activities), the contractor may not suspend its activities of exploration or production of hydrocarbons during any dispute resolution procedure, save when the National Hydrocarbons Commission rescinds the Round 1 Contract. The contractor expressly waives any right to diplomatic protection (Clause 26.8 of the contract), however, the contractor retains all rights recognised under international treaties (Clause 26.9).

Prohibition of payment of an indemnification in the case of administrative rescission

Article 20, paragraph 6 of the Mexican Hydrocarbon Law contains a prohibition of the payment of compensation in the case of administrative rescission: 'As a consequence of the administrative rescission, the Contractor transfers to the State the Contractual Area without charge, payment, or any kind of compensation'.

The transfer of the contractual area has to be performed according to the conditions established in the contract. The contractor retains the goods and installations which are not tied, or exclusively accessory, to the recovered area. Administrative rescission does not exempt the contractor from its obligation to remedy any damages and loss of income caused as provided for by the applicable legal provisions.

Administrative rescission is part of the exorbitant powers granted the state under an administrative contract, or *contrat administrative*, which is a French legal institution applied throughout Latin America, North Africa and many other parts of the world. However, whereas in France, the state has to act as *bon père* (good father) and compensate for interferences in the

contractual equilibrium,[6] the compensation obligation is widely ignored outside France. In particular, the Hydrocarbon Law expressly prohibits the payment of any kind of compensation, even if the state receives a substantial benefit from the transfer of the contractor's investment.

In light of the express prohibition of any payment, including of the sunk investment incurred by the contractor, the contractor will not recoup its investment, even if the state obtains a considerable bargain in the case of administrative rescission. This might violate international investment law under certain circumstances.

Contractual damages claims in the case of illegal administrative rescission

According to the second paragraph of Clause 26.4 (Federal Tribunals), '[t]he contractor will be able to initiate a procedure before an arbitral tribunal, under the terms of Clause 26.5, for the sole purpose of determining the existence of damages and lost profits, and if applicable, its quantification, as a consequence of an illegal administrative rescission determined by the Federal Tribunals'.

Damages claims of the contractor against the Hydrocarbons Commission are only admissible when the federal tribunals rule that the administrative rescission of the commission was made without due ground. Only in this case may the contractor claim damages. However, according to the second paragraph of Clause 26.4 (Federal Tribunals), such claim is limited to the effects of the improper contract rescission.

Therefore, the damages claim progresses as follows: if the federal tribunal declares the administrative rescission as inadmissible, the contractor may only recover the financial impact caused by the suspension of activities under Clause 26.7 (Non-Suspension of Activities), which permits the suspension of activities in the case of administrative rescission by the commission.

The last paragraph of Clause 25 (Indemnification) of the Round 1 Contract expressly establishes that '[w]ithout prejudice to the above, in no case the Parties shall be responsible for loss of income as from the notification of the rescission of the Contract', which means that the contractor may not claim lost profits. In the case of investments based on cashflows, the effect of the contractual violation is normally an impact on such cashflows. When prohibiting the recovery of lost profits, which subsist of cashflow minus expenses, the question arises as to what actually remains to be claimed, as the contractor would normally only recover lost profits and not the investment made because the investment would be recovered by the cashflows.

6 Héctor A Mairal, 'The Doctrine of the Administrative Contract in International Investment Arbitration' in Borzu Sabahi, Nicolas J Birch, Ian A Laird and José Antonio Rivas (eds), *Essays in Honor of Don Wallace, Jr* (Juris Publishing 2014).

If the federal tribunal admits the ground or grounds invoked by the commission for administrative rescission, the contractor is barred from arbitration under Clauses 26.4 (Federal Tribunals) and 26.5 (Arbitration) and is likely to be subject to the payment of penalties, direct damages and indemnification under Clauses 23.5 (Effects of Administrative Rescission or Contract Rescission) paragraph (a) and 25 (Indemnification).

State responsibility in the case of administrative rescission

Administrative rescission might amount to a violation of the so-called international standards of investment protection established by International Investment Agreements (IIAs) or the corresponding chapters in International Economic and Trade Agreements, such as the fair and equitable treatment standard or the prohibition of expropriation without compensation, which includes indirect expropriation. Examples of conduct that could be considered a violation of an international standard are: (1) administrative rescission based on political circumstances or being an excessive measure considering the degree of breach of contract; (2) the direct or indirect (without the transfer of the property) expropriation of the investment without compensation; and (3) exploitation of court procedures to delay or make it unnecessarily difficult to obtain the payment of damages and lost profits. The fact that an administrative rescission might be considered legal by a local tribunal does not mean that it cannot violate international law, provided that the threshold of international tort law standards is met.[7]

This will be further explained on the basis of a hypothetical case.

Hypothetical case

A foreign investor signs a gas exploration and production agreement for 25 years. It invests upfront $30m and finds oil reserves with a value of several billion dollars. Due to the market situation, it does not obtain the financing to start drilling, incurs considerable delay and violates a corresponding milestone in the project agreement. In the meantime, the host country changes governments and a populist president comes to power. The new government decides to rescind the project agreement with the investor and enter a new project agreement for the same production area with a political crony. The investor is barred from recovering its sunk investment due to the express prohibition in the law. The

7 Herfried Wöss, 'Systemic Aspects and the Need for Codification of International Tort Law Standards in Investment Arbitration' in Andrea K Bjorklund, John P Gaffney, Fabien Gélinas and Herfried Wöss, *Comprehensive Economic and Trade Agreement between the European Union and Canada* (CETA), (2016) 1 Transnational Dispute Management www.transnational-dispute-management.com/journal-browse-issues-toc.asp?key=65 accessed 5 March 2018.

foreign investor has two options: it might opt for administrative litigation in order to obtain a judgment declaring the administrative rescission illegal and then continue with commercial arbitration, or opt for investment arbitration. The following sections explore the latter option, specifically addressing the gas exploration and production agreement as a 'covered' investment and its protection under three relevant and commonly raised standards of investment treaty protection.

The contract as an income-generating asset or 'covered' investment

Large-scale investments are usually established to last for several decades and the investment agreement has emerged as a championed medium to customise the rights, risks, tasks and responsibilities of the parties involved. It is understandable that nearly all investment treaties list 'contracts' as covered by the term 'investment'.[8] In exploration and production agreements under the Hydrocarbon Law, the income to finance the investment and generate profits comes from the sale of the hydrocarbons to the market as established in Clause 2.1 (License) and Clause 15.2 (Commercialization of the Contractor's Production) of the contract, subject to the payment of the remuneration and the royalties to the state, in accordance with Clause 16.2 (Remuneration for the State) of the contract.

These contracts are considered atypical synallagmatic contracts, synallagmatic triallagmas or symbiotic contracts whereby the parties contribute assets of any kind and the income derives from a third party – the market – and not one of the contractual parties. Income-generating contracts are income-generating investments or assets and structurally distinct from typical synallagmatic contracts whereby one party delivers goods or services and the other pays in exchange.[9] It takes the contractor years to recoup its investment and start making profit. The reasonable allocation of the risks and benefits of the contract between the contractor and state is one of the essential features of such investment contracts, and is reflected in the reasonable expectations of the investor.

8 See 2008 Model México bilateral investment treaty (BIT), Art 1 http://investmentpolicyhub.unctad.org/Download/TreatyFile/2860 accessed 5 August 2016.

9 Herfried Wöss, Adriana San Román Rivera, Pablo T Spiller and Santiago Dellepiane, *Damages in International Arbitration under Complex Long Term Contracts* (Oxford University Press 2014); Adriana San Román Rivera and Herfried Wöss, *Damages in International Arbitration with respect to Income Generating Assets or Investments in Commercial and Investment Arbitration* (2015) 5 Yukos Special TDM and (2015) 2 Journal of Damages in International Arbitration 37; L Yves Fortier and Stephen L Drymer, 'Indirect Expropriation' in Meg Kinnaer, Geraldine R Fischer, Jara Minguez Almeida, Luisa Fernanda Torres and Mairée Uran Bidegain (eds), *Building International Investment Law: The first 50 years of ICSID* (Wolters Kluwer 2016); Thomas Wälde and Abba Kolo, 'Environmental Regulation, Investment Protection and "Regulatory Taking" in International Law' (2001) 50 International & Comparative Law Quarterly 811, 835.

Expropriation

Direct expropriations usually involve a physical and legal transfer of the investment. Indirect expropriations result where the physical and legal transfer may not take place, but government measures have an effect equivalent to direct expropriation. The standard indirect expropriation typically involves the eradication of an essential component of a protected right or neutralisation of its use or benefit. Accordingly, it is unlikely investment treaty arbitration tribunals would find minor contractual violations sufficient to satisfy the high threshold test demonstrating an expropriation has taken place.[10]

Administrative rescission of an investment contract, however, can be material and constitute an expropriation should it consequence, for example, a transfer of the contractual area from the contractor to the state, including the right of exploitation. For an expropriation to be considered legal, international law demands: (1) the existence of a public interest; (2) the interest is protected in a non-discriminatory manner; (3) in accordance with the due process of law; and (4) against the payment of prompt and adequate compensation.

In reference to the hypothetical case posed above, the public's interest may exist in the necessity to obtain income for the state because it is important that the extraction phase begin within the agreed timelines. However, where the administrative rescission is based on unrelated political motivations, it is likely that the arbitral tribunal will dismiss the alleged public interest and view the expropriation as illegal. This was the case in *British Petroleum v Libya*, where the sole arbitrator determined that 'the expropriation was unlawful because the measures had been adopted *for purely extraneous political reasons and were arbitrary and discriminatory in character*' [emphasis author's own].[11]

Similarly, a tribunal may rely on a proportionality analysis to assess the public interest of the expropriatory treatment, which prevents a state from taking measures that would severely affect the investor unless such a measure is justified by a substantial public interest. The tribunal in *Deutsche Bank v Sri Lanka*, in reference to *Tecmed v Mexico, Azurix v Argentina* and *LG&E v Argentina*, adopted this approach when it determined a regulatory action that frustrated a petroleum prices hedging contract with Sri Lanka's Supreme Court and its Central Bank that impeded the payments by the state to Deutsche Bank as illegitimate. On this point, the arbitral tribunal wrote:

10 See eg, *Flughafen Zürich y Gestión e Ingeniería IDC, SA v República Bolivariana de Venezuela*, ICSID Case No ARB/10/19, 454.

11 *British Petroleum v Libya*, Award, 10 October 1973 and 1 August 1974, 53 ILR 297, 329; August Reinisch, 'Legality of Expropriations' in August Reinisch (ed), *Standards of Investment Protection* (Oxford University Press 2008) 171, 181.

> '[T]he present case is not a typical case of regulatory action: the entire value of Deutsche Bank's investment was expropriated for the benefit of Sri Lanka itself… the actions by the Supreme Court and the Central Bank were not legitimate regulatory actions. They involved excess of powers and improper motive as well as serious breaches of due process, transparency and indeed a lack of good faith. It was the Central Bank which encouraged Deutsche Bank to enter a hedging agreement with CPC… Claimant has a legitimate expectation that a validly concluded hedging agreement with CPC would be in force in Sri Lanka and that its contractual rights would not be later interfered with by a regulator which was essentially and interested party to the transaction. The Tribunal cannot therefore accept Sri Lanka's excuse that its taking of Deutsche Bank's rights under the Hedging Agreement was the result of legitimate regulatory conduct. It was a financially motivated and illegitimate regulatory expropriation by a regulator lacking in independence'.[12]

The expropriatory measure(s) must also be delivered in a non-discriminatry manner. For example, in *LETCO v Liberia,* the tribunal concluded the expropriation of LETCO's contractually designated areas, which were later given to other foreign companies managed by political cronies of the Liberian Government, was discriminatory.[13]

The due process principle requires that: (1) the expropriation complies with procedures established in domestic legislation and international rules; and (2) the affected investor has an opportunity to have the case reviewed before an independent and impartial body.[14] In *Siag & Vecchi v Egypt*, the arbitral tribunal found that due process had been denied both substantially and procedurally because the investors' contract was cancelled and their investment expropriated without a valid reason some seven months before a fixed deadline for completing phase one of the project.

A legal expropriation must also be accompanied by payment of compensation, which has long been established under customary international law.[15] Under the Mexican Hydrocarbon Law, administrative rescission, particularly once the contractor has found hydrocarbons, appears to require compensation – in the amount of the fair market value of the investment – at the moment the expropriation takes place. Such compensation is justified because the state receives the corresponding

12 *Deutsche Bank AG v Democratic Socialist Republic of Sri Lanka*, ICSID Case No. ARB/09/2, Award, 31 October 2012, paras 522–524.

13 *Liberian Easter Timber Corporation (LETCO) v Republic of Liberia*, ICSID Case No ARB/83/2, Award, 31 March 1986, 343, 366.

14 UNCTAD *Expropriation, UNCTAD Series on Issues in International Investment Agreements II* (United Nations 2012) 36.

15 *Ibid*, 40.

value with the administrative rescission and benefits for the expropriation.

The general prohibition against paying compensation for an administrative rescission under the Hydrocarbon Law might violate Mexico's customary international law obligations and lead a court to view the expropriation as unlawful. This would give rise to damages and lost profits corresponding to the fair market value as assessed at the time of the award, in the case in which this is higher than the fair market value at the date of expropriation, plus the lost profits accrued between the date of the expropriation and the award. This is in accordance with the formula applied in the famous *Chórzow Factory* case.

A recent example of this approach is found in *Crystallex v Venezuela*, where the tribunal acknowledged the customary international law formula and asserted that expropriation must be accompanied by a 'prompt, adequate and effective compensation' and concluded that failure to compensate made the expropriation illegal. Hence, the tribunal condemned Venezuela to pay damages and lost profits of more than one billion dollars.[16] Other arbitral tribunals, however, may not account for lost profits as an element of an illegal expropriation and have recognised only the right of compensation in the form of fair market value as assessed at the date of expropriation plus corresponding accrued interest at a commercial rate calculated up to the date of the award.[17]

Denial of justice

The contractor may also allege a denial of justice for the unilateral modification by the state of the venue of dispute resolution. For instance, administrative rescission may bar the investor from the use of arbitration as an immediate option and force him or her to use local court procedure prone to political influence or where compensation is prohibited and lost profits are excluded. Common examples of denial of justice involve denial of access to courts, significant delays in the administration of justice, wrongdoing in judicial conduct and the responsibility derived from the resolution's content.[18]

Accordingly, denials of justice involve a significant degree of uncorrected maladministration of justice by the national legal system. Under the international denial of justice standard, for an investor to allege a violation,

16 *Crystallex International Corporation v Venezuela*, ICSID Case No ARB(AF)/11/2, Award, 4 April 2016, para 716.

17 *LG&E Energy Corp v Argentine Republic*, ICSID Case No ARB/02/1, Award, 25 July 2007, para 51.

18 *Azinian v Mexico*, ICSID Case No ARB (AF)/97/2, Award, 1 November 199, paras 102–103.

it is necessary that all the available judicial remedies have been exhausted.[19] The rationale connecting the exhaustion rule to the denial of justice standard is the notion that national justice systems are imperfect but self-correcting. If, however, reasonable recourse to effective local remedies is unavailable, a tribunal may deem the exhaustion rule a futile exercise.[20] Therefore, where local administrative courts are ill equipped to hear highly complex contract claims, a unilateral opting out from arbitration may be considered a denial of justice.

Typically denial of justice is considered as a part of fair and equitable standard of treatment, though it can be sourced to the minimum international standard of treatment accepted in international and national practice,[21] and therefore a safeguarded feature among Mexico's international obligations.

Fair and equitable treatment (FET)

According to the definition given in *Waste Management II v Mexico,* the state should refrain from conduct that is:

> 'arbitrary, grossly unfair, unjust, idiosyncratic, is discriminatory… or involves a lack of due process leading to an outcome which offends judicial propriety as might be the case with a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candour in an administrative process. In applying this standard it is relevant that the treatment is in breach of representations made by the host State which were reasonably relied on by the claimant'.[22]

The modern standard of FET is composed largely by notions of: (1) non-arbitrariness; (2) good faith; (3) non-discrimination; (4) transparency; (5) due process; and (6) legitimate expectations.

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19 *Pantechniki SA Contractors & Engineers v Albania*, ICSID Case No ARB/07/21, Award, 30 July 2009, paras 96–97.

20 *Ambiente Ufficio SPA and others v Argentina*, ICSID Case No ARB/08/9, Decision on Jurisdiction and Admissibility, 8 February 2013, paras 607–608; ST-AD *GmbH v Bulgaria*, PCA Case No 2011-06(ST-BG), Award on Jurisdiction, 18 July 2013, paras 365. But see *Ambiente Ufficio SPA and others v Argentina*, ICSID Case No ARB/08/9, Dissenting Opinion of Santiago Torres Bernardez to the Decision on Jurisdiction and Admissibility, 2 May 2013, paras 384–386 (Bernardez rejects the majority's reasoning finding that it is *de lege ferenda*); *ECE Projektmanagement International GmbH and Kommanditgesellschaft PANTA Achtundsechzigste Grundstucksgesellschaft mbH & Co v Czech Republic*, PCA Case No 2010-5, Award, 19 September 2013, para 4.746.

21 Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (2nd edn, Oxford University Press 2012) 179.

22 *Waste Management v United Mexican States (II)*, ICSID Case No ARB(AF)/00/3, Final Award, 30 April 2004, para 98.

As a legal standard, FET safeguards a foreign investor from a host of mistreatments. One manifestation of this guarantee embraces the principle of proportionality. To effectively address the parties' competing interests in a FET claim, tribunals are increasingly employing a proportionality analysis as an auxiliary principle to help mete out justice.[23] Proportionality analysis is often used in the domestic sphere and may involve weighing the objective of a state's measure against the degree of interference with a citizen's constitutional rights and freedoms.[24] In determining whether the treatment was unfair and inequitable in light of the circumstances, a proportionality analysis typically requires the tribunal to ask to what extent the host state may interfere with a foreign investment. This inquiry may involve weighing several factors, such as the purpose of the government measure, importance of the interest protected, importance of the interest held by the investor, availability of alternative and less intrusive measures, degree of interference and cost-benefit analysis.[25]

Where the host state's conduct is inequitable and unfair by frustrating the investors' legitimate expectations derived from a contract or legal provision, or the state acts in an arbitrary, discriminatory or non-transparent manner, proportionality analysis may operate as a middle ground between holding the firm to an informal exhaustion rule and completely disregarding claimants who are too quick out of the gate. The focus of the inquiry thus remains on the host state's interference while also accounting for militating factors. These factors may include: the effective availability, engagement or exhaustion of local remedies; whether the treaty employs a fork-in-the road provision or time-bar investment claims; whether the contract includes stabilisation clauses or a forum selection clause that express the parties' reasonable expectations, and so on, in addition to assessing the procedural fairness and substantive justice visited upon the foreign investor in light of the accused government mischief that may collectively assist the tribunal in reconciling the parties' colliding interests.

For example, in *Railroad Development Corporation (RDC) v Guatemala*,[26] RDC won a public, international tender in Guatemala in 1997, in order to provide the railway services in Guatemala with a usufruct right with the

23 Marc Jacob and Stephan Schill, 'Fair and Equitable Treatment: Content, Practice, Method' in Marc Bungenberg et al (eds) *International Investment Law* (Hart 2015), 738.

24 See eg, *Canadian Charter of Rights and Freedoms*, Part I of the Constitution Act, 1982, [*Charter*] s 1. See also *R v Oakes*, [1986] 1 SCR 103.

25 Benedict Kingsbury and Stephan Schill, 'Investor-state Arbitration as Governance: Fair and Equitable Treatment, Proportionality and the Emerging Global Administrative Law' IILJ Working Paper 2009/6 (Global Administrative Law Series) pp 21–40.

26 *Railroad Development Corporation (RDC) v Guatemala*, Award, 29 June 2012, ICSID Case No ARB/07/23.

obligation to rebuild the railway system. The usufruct had a 50-year duration in order to facilitate the rebuilding and operation of the Guatemalan railway system through Ferrovías Guatemala (FVG). On 25 November 1997, FVG entered into a usufruct agreement with Ferrocarriles de Guatemala (FEGUA), a state-owned company. A usufruct agreement was also entered for the rolling stock. In 2005, the general attorney of Guatemala issued a *lesividad* opinion, which was published by the Guatemalan Government on 11 August 2006, alleging that its own officials violated the rules of the public tenders by giving the property in usufruct to FEGUA.[27]

The tribunal found that the *lesivo* procedure possessed characteristics that may have been easily abused by the Guatemalan Government based on the alleged illegality of acts of public functionaries in the compliance of public tender laws. In other words, an investor in Guatemala would have no certainty that, at any time within three years of its investment, the state may declare the investment *lesivo*, irrespective of the investor's performance of its obligations. Under these circumstances, the *lesivo* remedy was applied under a cloak of formal correctness, allegedly in defence of the rule of law; but, in fact, for extracting concessions unrelated to the findings of the *lesivo*. Even if FEGUA's actions were *ultra vires* and not pursuant to domestic law, their propriety was not convincingly established for the tribunal and it determined that the Guatemalan Government should be precluded from raising violations of its own law as a defence when, for a substantial period of time, it knowingly overlooked these laws, obtained benefits from them and had the power to correct them. The tribunal concluded by saying that the manner in which the Guatemalan Government applied the *lesivo* remedy constituted a breach of the minimum standard of treatment, which was, in the words of *Waste Management II*, 'arbitrary, grossly unfair and unjust'.[28]

In *Crystallex v Venezuela*, the claimant alleged that Venezuela denied Crystallex a permit to exploit gold deposits in Las Cristianas and that the Corporación Venezolana de Guayana, a state-owned company for the economic development in the region, terminated a mining operation contract (MOC) with Crystallex in February 2011. The tribunal resolved that Venezuela breached the fair and equitable treatment requirement due to the fact that the rescission of the MOC was based on different, politically motivated reasons unrelated to those alleged by state authorities, which constituted an arbitrary act.[29]

27 *RDC v Guatemala*, paras 30–37.

28 *RDC v Guatemala*, paras 233–235.

29 *Crystallex International Corporation v Venezuela*, ICSID Case No ARB(AF)/11/2, Award, 4 April 2016, para 610–614.

Conclusion

A 'perfect storm' is an expression that describes an event in which a rare combination of circumstances aggravate a situation drastically. The legal setting during Mexico's energy reform has the markings of a perfect storm just waiting to happen. Under the 2014 Mexican Hydrocarbon Law, Mexico is not obliged to indemnify a foreign investor for unilaterally terminating or changing an administrative contract. The current status of Mexican law restricts complaints of this nature to local administrative courts for redress. As a Latin American country, Mexico's legal tradition draws on the civil law legal tradition and is influenced by the Calvo Doctrine, which advanced local forms of justice over international dispute resolution. Permeations of the Calvo Doctrine appear to persist in Mexico as it has positioned itself to leave open the possibility that local remedies may precondition investment arbitration. For example, in *Loewen v United States*, Mexico filed a North American Free Trade Agreement (NAFTA) Article 1128 submission, which solidified its intent when it wrote: 'Mexico consistently has taken the position both in oral argument and in written submissions that the State's legal system as a whole must be examined to determine whether there has been a breach of the NAFTA'.[30]

Although the initial approach was to exclude implicit versions of the exhaustion rule from international investment law,[31] the requirement has survived and has taken on a new and expanding role. For claims involving denials of justice, judicial finality is generally a base requirement. For expropriation and FET claims, several decisions suggest foreign investors ought to consider available and effective local remedies prior to advancing their claims to international arbitration. Despite the exhaustion rule's informal existence, its repeated acceptance and application in investor-state dispute settlement means a sacrifice of certainty and predictability in international investment law in favour of providing local authorities an opportunity to self-correct. At a macro-level, it puts into question the normative function of international investment as an alternative to domestic tribunals.[32] At a micro-level, prudent investors are faced with a difficult decision to pursue local remedies, potentially wasting money and time, and exposing themselves to further injury attributable to the host state, or to

30 Loewen Group, Inc and Raymond L. *Loewen v United States of America*, ICSID Case No ARB(AF)/98/3, Mexico's NAFTA Article 1128 Submission, 9 November 2001, 7.

31 See eg, ICSID Convention, Art 26.

32 Campbell McLachlan, Laurence Shore and Matthew Weiniger, *International Investment Arbitration: Substantive Principles* (Oxford University Press, 2007): 'one of the purposes of investment arbitration is to provide a neutral forum for dispute resolution of investor-State disputes'.

take a chance on investor-state arbitration, hoping to skilfully distance their arguments from any discussion of the exhaustion rule. For the host state, it is an opportunity to install multiple levels of review within its domestic legal infrastructure to delay investment arbitration or, for the sake of clarity, expressly include or exclude the exhaustion rule into their treaty negotiating practices[33] – an opportunity Mexico is pressing for advantage.

But international investment law operates distinctly from municipal law and where indemnification is unavailable through domestic means, as is the situation under the 2014 Mexican Hydrocarbon Law, a foreign investor may seek compensation under an applicable investment treaty. To accept otherwise would permit Mexico, and like-minded national lawmakers, to override their international obligations with domestic law. The emphasis tribunals place on party autonomy indicates that parties may proactively concretise their expectations, but, undoubtedly, greater clarity and consistency would benefit all stakeholders and enhance the credibility of the system.

33 See US-Ecuador BIT, Art II(3)(b): 'A measure may be arbitrary or discriminatory notwithstanding the fact that a party has had or has exercised the opportunity to review such measure in the courts or administrative tribunals of a Party'.