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MEXICO'S REFORMS TO HYDROCARBON LAW AND ELECTRICITY INDUSTRY LAW MAY VIOLATE INVESTMENT TREATY PROTECTIONS

To Our Clients and Friends:

Recent amendments to Mexico's Hydrocarbon Law ("**Hydrocarbon Reform**") and Electricity Industry Law ("**Electricity Reform**") may have a significant impact on the operations of foreign investors in the energy sector in Mexico. The recent legislative amendments curtail the market power of private electricity, and oil and gas producers in Mexico and discriminate against foreign investors.

The Hydrocarbon Reform grants the Government broad discretion to suspend or refuse to renew existing permits granted to private companies, with corresponding provisions granting State-owned company Petróleos Mexicanos ("**Pemex**") the right to take over the facilities of private companies who no longer have a permit without compensation.[1] At its core, the Hydrocarbon Reform aims to recalibrate the existing regulatory framework to revive the dominance of Pemex and limit the prevalence of privately owned oil and gas companies in Mexico.[2]

Similarly, the Electricity Reform disadvantages private electricity providers by granting dispatch preference to electricity generated by State-owned company Comisión Federal de Electricidad ("**CFE**").[3] Prior to this amendment, Mexico's electrical grid rules prioritized dispatch on the basis of the least expensive generated electricity.[4] The Electricity Reform has been developed to consolidate CFE's market participation to the detriment of private producers, many of whom generate wind and solar energy.[5]

A judge in Mexico has ordered an indefinite suspension on the implementation of the Reforms pending resolution as to their constitutionality under domestic law.[6] If the suspension is lifted, foreign investors may well have an investment treaty claim as set out further herein.

Mexico's reforms to the energy sector may violate investment treaty protections

The Hydrocarbon and Electricity Reforms may violate investment treaty protections owed by Mexico to foreign investors who have invested in the State and are protected by an applicable investment treaty. For example, investors from the United States and Canada can arbitrate claims directly against Mexico for breaches of the protections granted by the investment chapter in the Agreement between the United States of America, the United Mexican States, and Canada ("**USMCA**") and its predecessor the North American Free Trade Agreement ("**NAFTA**").[7] In fact, in response to Mexico's ongoing discriminatory treatment of foreign investors, three U.S. companies filed claims on 12 May 2021 before the International Centre for Settlement of Investment Disputes ("**ICSID**")—Finley Resources Inc, MWS

Management Inc and Prize Permanent Holdings LLC—on the basis that Mexico had breached its obligations under Chapter 14 of the USMCA and Chapter 11 of NAFTA.

In addition, investors from Australia, Brunei, Canada, Chile, Japan, Malaysia, New Zealand, Peru, Singapore and Vietnam may also have a claim against Mexico pursuant to the investment chapter in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership ("**CPTPP**"). Mexico is also party to a number of bilateral investment treaties with more than 20 States that provide for recourse to international arbitration.[8]

The right to national treatment

Investment treaties commonly include a protection that requires the host State to treat investments of foreign investors no less favorably than it treats domestic investors in "like circumstances."[9] Arbitral tribunals considering the meaning of "like circumstances" have found that this has "a wide connotation" that requires an assessment of whether "a non-national investor complaining of less favourable treatment is in the same 'sector' as the national investor. . . . [this] includes the concepts of 'economic sector' and 'business sector.'"[10]

While it is not necessary to prove an intent to discriminate, tribunals have held that a State measure which "on its face, appears to favour its nationals over non-nationals" is a "factor[that] should be taken into account."[11] Arbitral tribunals have added that "[d]iscrimination does not cease to be discrimination, nor to attract the international liability stemming therefrom, because it is undertaken to achieve a laudable goal or because the achievement of that goal can be described as necessary."[12] A previous tribunal found Mexico liable for breach of the national treatment protection where a controversial tax "was enacted for the purpose of protecting the domestic Mexican sugar industry from foreign competitors."[13] The tribunal awarded the investor in excess of US$ 33.5 million in damages.[14]

Mexico's Reforms are facially discriminatory to foreign investors operating side-by-side with State-owned operators Pemex and CFE, with the laws being structured in a manner that the adverse impact will be felt almost exclusively by foreign investors. President Andrés Manuel López Obrador and other members of the Government have likewise stated publicly that the purpose of the Reforms is to reestablish State control over the energy sector.[15] As a consequence, it is questionable whether Mexico is complying with its obligation to provide national treatment under various investment treaties to which it is Party.

The right to fair and equitable treatment

Most investment treaties also include a protection granting investors the right to fair and equitable treatment by host States. This includes a right to "protection of [a foreign investor's] legitimate expectations, protection against arbitrary and discriminatory treatment, transparency and consistency."[16]

Many of Mexico's investment treaties require Mexico to treat the investments of a foreign investor fairly and equitably.[17] Arbitral tribunals have held that host States like Mexico cannot exercise legislative

power "to act in an arbitrary or discriminatory manner, or to disguise measures targeted against a protected investor under the cloak of general legislation."[18]

Given the targeted purpose and impact of the Reforms, impacted foreign investors may arguably have a claim that Mexico has breached its fair and equitable treatment obligation by arbitrarily discriminating against foreign investors. The changes in the legislative framework affecting hydrocarbon permitting and electricity distribution may likewise amount to a violation of foreign investors' legitimate expectations.

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Investment treaties can offer important protections to foreign investors operating in markets that present significant political and legal risks. Gibson Dunn lawyers have extensive experience advising clients in disputes against States for breaches of investment treaties. If you have any questions about how your company can take advantage of such protections, or if you think your company has an investment treaty claim based on Mexico's Hydrocarbon or Electricity Reforms, we would be pleased to assist you.

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[1] *See* here.

[2] *See* here.

[3] *See* here.

[4] *See* here.

[5] *See* here.

[6] *See* here and here.

[7] Canadian and U.S. investors in Mexico are able to file claims against Mexico before July 1, 2023 pursuant to the investor-State dispute settlement provisions available under the USMCA's predecessor, NAFTA, provided that the dispute arises out of investments made when NAFTA was still in force and remained "*in existence*" on July 1, 2020. *See* USMCA, Annex 14-C. Thereafter, Canadian investors can seek recourse against Mexico under the CPTPP, and U.S. investors can seek recourse under Annex 14-D and Annex 14-E of the USMCA.

[8] *See, e.g.*, Kuwait-Mexico BIT, Article 10; China-Mexico BIT, Article 12; Republic of Korea-Mexico BIT, Article 8.

[9] *See*, *e.g.*, Bahrain-Mexico BIT, Article 3 ("Each Contracting Party shall accord to investors of the other Contracting Party and their investments, treatment no less favourable than that it accords, in like circumstances, to its own investors"); Belarus-Mexico BIT, Article 3 ("Each Contracting Party shall

accord to investors of the other Contracting Party treatment no less favourable than that it accords, in like circumstances, to its own investors"); Mexico-Slovakia BIT, Article 3 (same).

[10] *S.D. Myers, Inc. v. Government of Canada*, UNCITRAL, Partial Award, 13 November 2000, ¶ 250.

[11] *S.D. Myers, Inc. v. Government of Canada*, UNCITRAL, Partial Award, 13 November 2000, ¶ 252.

[12] *Corn Products International Inc. v. United Mexican States*, ICSID Case No. ARB(AF)/04/1, Decision on Responsibility, 15 January 2008, ¶ 142; *Quiborax S.A. and Non Metallic Minerals S.A. v. Plurinational State of Bolivia*, ICSID Case No. ARB/06/2, Award, 16 September 2015, ¶ 253.

[13] *Archer Daniels Midland Co. & Tate Lyle Ingredients Americas, Inc. v. United Mexican States*, ICSID Case No. ARB(AF)/04/05, Award, 21 November 2007, ¶ 210.

[14] *Archer Daniels Midland Co. & Tate Lyle Ingredients Americas, Inc. v. United Mexican States*, ICSID Case No. ARB(AF)/04/05, Award, 21 November 2007, ¶ 293.

[15] *See* here and here.

[16] *Crystallex International Corporation v Bolivarian Republic of Venezuela*, ICSID Case No. ARB(AF)/11/2, Award, 4 April 2016, ¶ 543.

[17] *See*, *e.g.*, United Arab Emirates-Mexico BIT, Article 4 ("Each Contracting Party shall accord to investments . . . fair and equitable treatment . . .); Turkey-Mexico BIT, Article 4 (same).

[18] *Rusoro Mining Ltd. v. Bolivarian Republic of Venezuela*, ICSID Case No. ARB(AF)/12/5, Award, 22 August 2016, ¶ 525.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these issues. Please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's International Arbitration Practice Group, or any of the following:

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