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Demystifying Energy Investment Disputes in Mexico Through the New USMCA

By Carlos Vejar and Juan Pablo Moyano*

Some stakeholders have interpreted Chapter 8 of the United States-Mexico-Canada Agreement as having no obligations for Mexico in the hydrocarbons sector. However, even without a specific chapter regulating the energy market, an energy investment from a U.S. investor will be covered through the more general investment protections, although subject to certain caveats. This article identifies several key provisions for U.S. investors in Mexico's hydrocarbons market.

Although the United States-Mexico-Canada Agreement ("USMCA") is still pending Congressional approval in Canada and the United States, Mexico's Senate approved it on June 19, 2019.[1] Along with the many changes that the new agreement brings, there has been some unease regarding the current protections in the energy sector. Interpretation of Chapter 8 of the agreement has led to an incorrect notion, reflected by some stakeholders, that the USMCA contains no obligations for Mexico in the hydrocarbons sector. This article identifies where to find the key provisions for U.S. investors in the hydrocarbons market.[2]

THE UMSCA'S HYDROCARBONS AND INVESTMENT REGULATION

The USMCA's 34 chapters, numerous annexes and 14 side letters regulate a wide variety of trade-related topics. However, unlike the North American Free Trade Agreement ("NAFTA"), which dedicated a specific section to the energy

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1 Full text of the USMCA is available on the Office of the United States Trade Representative website at https://ustr.gov/trade-agreements/free-trade-agreements/united-states-mexico-canada-agreement/agreement-between.

2 Canadian investors will find their investments protected in Mexico under the Comprehensive and Progressive Agreement for Trans-Pacific Partnership ("CPTPP").

sector, the USMCA appears to limits its regulation to a single Chapter 8[3] composed of a two-paragraph article, focused mainly on Mexico.[4]

Under Article 8.1, the USMCA states recognize Mexico's sovereign right to reform its legal regime, and Mexico's ownership of all hydrocarbons.[5] At its core, this language is nothing more than a mere recognition of the existing Mexican legal framework regulating hydrocarbons, and reflects the reality of the principles of sovereignty: Countries have an inherent right to modify their laws and regulate industries as they see fit. This, however, does not mean that Mexico has not accepted any obligations in its energy sector under the USMCA, nor that any violation to an established investment could not give rise to a violation of the treaty.[6]

In this regard, Chapter 8 is nearly irrelevant,[7] as it does not interfere with the more general protections for investments provided for in the USMCA. In this regard, the investment protection standards are contained in Chapter 14, which would apply to U.S. investments in the energy sector, and would not contradict the statements contained in Article 8.1. In other words, even without a specific

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[3] Titled "Recognition Of the United Mexican States' Direct, Inalienable, and Imprescriptible Ownership of Hydrocarbons."

[4] However, the UMSCA does contain certain specific provisions related to the energy sector. First, there is a national treatment exception for Mexico's energy export license program in Article 2.A.3. Second, additional rules of origin provisions in Chapter 4 allow for up to 40 percent of the volume of crude petroleum goods classified under HS 2709 to be non-originating and 25 percent for refined petroleum goods under HS 2710 to be non-originating. These provisions are broader than that in NAFTA. For more information, see the U.S. International Trade Commission report: "U.S.-Mexico-Canada Trade Agreement: Likely Impact on the U.S. Economy and on Specific Industry Sectors" at https://www.usitc.gov/publications/332/pub4889.pdf.

[5] For example, Article 11 of the Mexican Hydrocarbons Law expressly mandates that all contracts for exploration and extraction must indicate that hydrocarbons are property of the state.

[6] Generally, a violation of an investment treaty protection, even though a change in the applicable legal regime, could ultimately lead to: a) a commercial dispute under the terms of a commercial agreement between the Mexican government and the investor, b) negotiations to commercially compensate the affected party, c) investment disputes under the available mechanisms for settlement of investment disputes and the possible awarding of damages, and d) possibly the denouncement of the violation by another state party.

[7] See the U.S. International Trade Commission report assessing the likely impact of the USMCA on the U.S. economy as a whole and on specific industry sectors and the interests of U.S. consumers at https://www.usitc.gov/publications/332/pub4889.pdf. The report makes a single footnote reference 208 to Chapter 8 of the USMCA, as follows: "Chapter 8 of the USMCA is dedicated to hydrocarbons, but only contains provisions related to Mexico's ownership of hydrocarbons contained within its territory and sovereign right to reform its constitution."

chapter regulating the energy market, an energy investment from a U.S. investor will be covered through the more general investment protections. This, however, is subject to certain caveats.

First, Chapter 14 provides for all the standard investment protections contained in modern treaties, including Most Favored Nation, National Treatment, and the Minimum Standard of Treatment—which in turn includes Fair and Equitable Treatment as well as Full Protection and Security. However, the dispute resolution mechanism pathways are fragmented within the chapter. Annex 14-D provides for investment disputes only with regards to National Treatment, Most-Favored Nation, or Expropriation, but does not include Minimum Standard of Treatment. It also mandates that the parties first attempt to negotiate and appear before domestic courts for a 30-month period.

Annex 14-E, on the other hand, provides for disputes arising from government contracts in specifically covered sectors. This annex covers all of the investment protections with no need for a pre-litigation period, only negotiations. This is important because investments in the oil and natural gas market are expressly considered a "covered sector" in Section 6(b), and as such, an investment would be entitled to all of the protections and to initiate arbitration based on Annex 14-E.

Ever since the 2013 reforms to the Mexican Constitution, all private investment in the energy sector must take place through governmental contracts. For example, Mexico's Hydrocarbons Law states that the government will grant contracts for the exploration and extraction of hydrocarbons through a public tender process.[8] Thus, these contracts are granted and signed by the federal government, and would fall within the USMCA's category of government contracts.

THE USMCA EXCEPTIONS

Having indicated that government contracts in the energy sector are entitled to the entirety of treaty protections, it is then important to consider whether any exceptions exist within the treaty. Exceptions can generally be found either in Chapter 32, titled "Exceptions and General Provisions," or in the existing annexes to the agreement. Investment and Services Annexes are, in essence, reservations by each state party to specific measures that will not be covered by the treaty agreements and protections.[9]

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[8] Mexican Hydrocarbons Law, Article 23.

[9] Generally, see the USMCA's Annex 1 at https://ustr.gov/sites/default/files/files/agreements/FTA/USMCA/Text/NCM-Annex_I_Mexico.pdf, which contains the introductory notes to the various Annexes.

First, regarding Chapter 32, although it has no article that states an express exception for the energy sector, Article 32.11 recognizes that, for purposes of Chapter 14 on investments, Mexico reserves its right to adopt or maintain a measure with respect to specific sectors not included already in the schedules to Annexes I, II, and IV of the agreement.

Article 32.11, however, is qualified by the following statement:

> only to the extent consistent with the least restrictive measures that Mexico may adopt or maintain under the terms of applicable reservations and exceptions to parallel obligations in other trade and investment agreements that Mexico has ratified prior to entry into force of this Agreement, including the WTO Agreement, without regard to whether those other agreements have entered into force.

Second, a review of the various annexes shows that Mexico has not adopted a specific measure regarding the hydrocarbons sub-sector either, and as such, Chapter 14 would apply without reservation. In any case, and because of the text of Article 32.11, should Mexico adopt a new measure, its application would be restricted in light of any other less restrictive measure found in any other trade agreement ratified prior to the USMCA (e.g., those found in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership).[10]

CONCLUSION

In conclusion, energy investments by U.S. investors will still be entitled to the full protection of the USMCA as long as they are made through governmental contracts. Furthermore, future modifications to the legal regime may be limited in their application based on similar or parallel reservations that exist in other treaties already ratified by Mexico. Should this situation arise, a case-by-case analysis would be necessary.

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[10] For example, Mexico has established in Annexes I, II, and IV various reservations for the hydrocarbons sector. Full text of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership is available at https://www.mfat.govt.nz/en/trade/free-trade-agreements/free-trade-agreements-concluded-but-not-in-force/cptpp/comprehensive-and-progressive-agreement-for-trans-pacific-partnership-text/.