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## Energy Reform in Mexico: Lessons and Warnings from International Law

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# The Energy Reform in Mexico

## Lessons and Warnings from International Law

BY GUILLERMO J. GARCIA SANCHEZ

### Abstract

**THE ARTICLE ANALYZES** some of the contents of the Mexican energy reform of 2013 and warns on the international legal implications that the path that Mexico has chosen to follow could bring to its economy and international relations. Concretely, it argues that in order to avoid falling into the same mistakes made by other Latin American countries in the region, Mexico must consider its obligations contained in international treaties signed with the United States on transboundary resources as well as its obligations in bilateral investment treaties that protect foreign investors from certain government acts and policies.

In December 2013, the international media reported, to the surprise of many, that the Mexican Congress approved an energy reform that will radically transform a seventy-year-old state-oriented policy that was an essential part of Mexico's national identity.<sup>1</sup> The central theme of this article

is to analyze some of the contents of this reform and to make a cautious warning on some of the international legal implications that the path that Mexico has chosen to follow could bring to its economy and to its international relations. Concretely, the article argues that the legislative process that will implement the energy reform in the upcoming months needs to attend to two elements regarding Mexico's international legal obligations: the provisions contained in the 2012 Agreement Between the United States of America and Mexico Concerning Transboundary Hydrocarbon Reservoirs in the Gulf of Mexico (the 2012 Treaty)<sup>2</sup> and the obligations contained in several bilateral investment treaties (BITs) signed by Mexico that protect foreign investors from certain government acts and policies. Other states in the region have gone down this path before and for a diversity of reasons have ignored the international obligations to which they agreed, triggering numerous disputes and conflicts that eventually cost

millions in damages and compensations. Mexico has the chance to learn from the mistakes of its peers in the region and even to be institutionally creative in the way it assumes its international obligations in the future; otherwise, the story of States repenting years later will repeat itself, to the detriment of Mexico's national finances.

### The Energy Reform of 2013

Before addressing the international law aspect of the reform, it is important to understand the essence of the constitutional amendment.<sup>3</sup> The most important aspect in relation to this article is the fact that the energy reform amended the Mexican Constitution to open up the possibility for the Mexican State to sign contracts with private parties, including multinationals, for the exploration and exploitation of hydrocarbon resources (article 27). Before the reform, only *Petróleos Mexicanos* (Pemex), the State-owned petroleum company, could conduct these activities on behalf of the State. The Constitution still prohibits the signing of concession agreements, but in the transitory articles, it allows the State to sign a variety of contracts that were forbidden before. For example, the reform affirms that the State can sign joint profit and production contracts, service contracts, and licenses with private companies (transitory provision 4). The transitory provisions also mention that the State can pay the private party: cash, in the case of service contracts; a percentage of the profit, in the case of joint profit agreements; a percentage of the production, for joint production agreements; and an onerous transfer of the hydrocarbons once they have been extracted, for the license agreements; or a combination of all of the above. The decision on which contract will be adopted according to the reform depends on the one that will maximize the government's income in the long term. In terms of the authorities in charge of implementing the reform, the Secretary of Energy, the National Com-

mission on Hydrocarbons, and the Energy Regulatory Commission have joint powers to execute and regulate different aspects of the agreements (article 27 and transitory provisions 6 and 10).

### The 2012 Treaty Between Mexico and the United States

In December 2013, just a couple of days after the Mexican Congress adopted the energy reform, the U.S. Congress approved as part of the Bipartisan Budget Act of 2013 the integration of the Agreement Between the United States and Mexico Concerning the Transboundary Hydrocarbon Reservoirs in the Gulf of Mexico.<sup>4</sup> With this act, the treaty that took more than twenty years to negotiate and was signed in 2012 entered into force between both countries and regulates the resources that, according to international law, both States are entitled to exploit.<sup>5</sup> The treaty, in essence, will change the way the energy relations between Mexico and the United States can develop in the future since it opens the possibility of exploiting an estimate of 172 million barrels contained in deep water reservoirs.<sup>6</sup> Furthermore, it places the security of the hydrocarbon resources located in the Gulf of Mexico under the protection of an international treaty and fosters a joint development between Mexico and the United States to exploit them efficiently, equitably, and in a secure way. There are many aspects of the treaty that are interesting for the development of international law in the matter, but for the sake of this article, four points are relevant and need to be stressed to avoid future conflicts between both States.

First, the treaty's heart and soul is located in its preamble, where it states the principles that will guide the life of the legal framework of the treaty to archive "safe, efficient, equitable and environmentally responsible exploitation of transboundary hydrocarbon reservoirs." The treaty does not expand on what the parties consider

to be an “efficient,” “equitable,” “safe,” or “environmentally responsible” exploitation, hence it leaves open to interpretation how these principles might develop in the life of the treaty. This has several risks in light of the energy reform: for example, by not determining the understanding of each principle and by not hierarchizing them, the operators of the agreement, or an arbitrator if a dispute arises, will have to interpret each one and balance them in case there is conflict. What if the unitization agreement is efficient but not safe or environmentally responsible? What if it is equitable but inefficient? And even more important for the sake of the energy reform, what if the domestic legislation in Mexico defines efficiency in terms of government revenues and not in terms of profitability to the private contractors? The answers cannot be obtained from the language drafted in the treaty and hence are left subject to interpretation.

Second, to achieve the above-mentioned principles, Mexico and the United States agreed that the treaty would design “cooperative agreements based primarily on principles of unitization.” Articles 6 and 7 of the treaty establish the process to sign and the content of the unitization agreements. In essence, they must be negotiated by the licensees from each side of the border treating the reservoir as a unit, which entails that the States must share the costs and the profits of its exploitation equitably. In addition, the unitization contracts proposed by the licensees must be approved by each of the State agencies. This raises several questions in the face of the energy reform. The regulatory framework of the reform must include a chapter that deals with the contracts in the borderline with the United States. The way things stand today, it is unclear the type of contractual relationship that the Mexican government could have with private companies in those areas that could respect the agreement signed with the United States. The

treaty only mentions one type of contract: licenses. But the Mexican legislation, as explained above, contains several options, and each one, according to the reform, must maximize in the long term the government’s profit from the exploitation of these resources. Balancing the rights of the State, the rights of the contractors, and the provisions of unification in the treaty is going to be a hard task and must be addressed in the secondary legislation if the Mexican State wants to avoid a dispute with the United States on the issue.

Finally, the dispute resolution mechanisms of the treaty are far from efficient. For instance, the treaty created a Joint Commission to determine many elements of the life of the treaty, including resolving disputes regarding its interpretation. This, however, does not make the Commission a strong and independent body; in fact, it’s the opposite. The members of the Joint Commission are designated by the parties, but there are no qualification requirements regarding them; the Commission is composed of four members, two designated by each State, and does not contain any procedure in case its decisions are locked. In the case the Commission is unable to reach an agreement in many aspects of the treaty, the issue is thrown back to the parties or to an arbitrator—only if it’s a technical issue it is resolved by an expert. Finally, the Commission does not have an independent budget and each State has to financially support its designated members. Hence, as opposed to being an independent and strong body that could make unbiased decisions on the benefit of the treaty’s life, the Joint Commission is closer to a binational political commission that tries to coordinate policies but has almost no power over the parties. Mexico and the United States have done better in the past when it comes to creating this type of organism. In fact, in a very similar situation, the case of transboundary rivers, both States signed an agreement back in 1944 where they created

a commission with the rank of an “international organization” that has a joint budget to technically determine apportionment of inland water between both countries.<sup>7</sup> This binational organization has been relatively efficient in its tasks and has been able to work even under pressure of governors, mayors, and farmers on both sides of the border.<sup>8</sup>

### The Protection of Foreign Investors in Mexico

Mexico has signed more than thirty bilateral investment treaties and several free trade agreements that contain a section on the protection of investment, like Chapter 11 of NAFTA, where in essence the State agrees to give foreign investors a particular set of rights and legal resources.<sup>9</sup> In general, these include the right to a fair and equitable treatment, principles on the procedure and calculation of compensation for expropriations, nondiscrimination, national treatment, and full protection and security of their investment.<sup>10</sup> Most importantly these treaties give the right to the foreign investor to initiate mandatory arbitration proceedings against the government if the investor considers that his or her rights have been violated due to state action or inaction. Mexico has been found guilty in the past for certain acts against foreign investors and has paid a substantial amount of money in damages and compensation.<sup>11</sup> Nevertheless, one of the industries that was excluded from these treaties was the hydrocarbon sector. This is so because it was considered that only Pemex would develop activities in these areas and that foreign investment was expressly forbidden in this area.

With the entry into force of both the treaty of 2012 and the energy reform of 2013, questions will emerge regarding the protection of the investors that will be subject to both regimes. In principle, international foreign investment law protects the contracts signed by the investors with the

government.<sup>12</sup> These are considered as any other investment in the foreign country. The risk with the energy reform now is that if the secondary legislation is not drafted in an efficient way, clearly establishing the type of acts that the government can take—such as forcing a unification agreement in the borderline, for instance—international disputes could arise in the future. For example, if a petroleum company agrees to invest in Mexico under certain terms, and the government decides to correct the agreement to regain control of the production of the field or it modifies the legal context in which the investment was done in the future, then Mexico could face claims in an international investment arbitral tribunal. This has happened in the past to other countries in the region. It is not uncommon to find stories of Latin American governments that decide to open particular sectors of the economy that were previously fully controlled by the State and then change their minds years later when they realize that the reforms are too aggressive and that they left the government on the wrong side of the equation. Any amendments to the legislative and contractual context when the foreign investor arrived to the State can be translated into claims of breaches of a BIT and hence the State would have to pay damages and compensation for modifying its policies. Examples of the above can be found in the case of Ecuador when it modified its fiscal law on the exploitation of hydrocarbons<sup>13</sup> and Venezuela when it modified its national hydrocarbons law to strengthen the control of the State over the exploitation of the oil fields in the Orinoco Belt.<sup>14</sup>

### Conclusion

If the purpose of the 2012 treaty and the 2013 energy reform is to expand the investment in the hydrocarbon sector of Mexico, then a deep study and understanding of the international law implications of these innovations is necessary. The risk of



making a mistake or of being too ambiguous regarding the policies adopted and the legislation implemented could provoke several claims and years of costly litigation with the U.S. government or with foreign investors. This story has been told before in the region, there is no need to replicate it in Mexico if things are done appropriately. On the contrary, if Mexico is able to draft a modern secondary law that integrates more deeply the energy relation with the United States and foreign companies in an efficient, equitable, and secure way, the future of the North American regions could be secured and it could serve as an excellent model for other relations. For example, it is a fact that transboundary resources are also located with the borders of other parts of the Gulf, like the borderlines between Mexico, the United States, and Cuba, or the borderline between Guatemala and Mexico. Furthermore, the shale gas reservoirs in the borderline between Mexico and the United States could also benefit from the experience that the exploitation of the fields according to the treaty of 2012 could bring.

If things are done in an inappropriate manner and Mexico is forced to modify legal contexts after the investments are done or if the agreements in the borderline end up in claims tribunals, then the political turmoil in Mexico when the news of the arbitrations are out will force the State to go back to nationalistic rhetoric that can only bring more tension to the region. Rather than being an example of the development of a secure energy region, Mexico will become one more case of a wrongly implemented opening to foreign investment and a consequent fall back into nationalistic policies that not only keeps the State from using its resources efficiently but that translates into litigation that could eventually cost millions of dollars of national income in damages and compensation.

**Guillermo J. Garcia** is a Mexican lawyer trained and specialized in international law affairs. He holds a bachelor's degree in law and a bachelor's degree in international relations both from ITAM University in Mexico, where he achieved the highest honors and several awards for his research on international legal solutions on transboundary hydrocarbon resources between the United States and Mexico. Before being admitted to Harvard Law School's doctoral degree on juridical science program, he obtained a master's degree in international law from the Fletcher School of Law and Diplomacy in 2011. His professional experience includes practice as an associate in an international law firm specialized in international investment arbitration, lobbying the Mexican Congress for the introduction of political reforms, presenting briefs before the Inter-American Court of Human Rights, advising the Mexican Ministry of Foreign Affairs, and clerking for a Justice of the Supreme Court of Mexico. His current line of research includes comparative constitutional law, international adjudication, and the impact of international law in Latin American democracies.

## References

<sup>1</sup> See, for example, *The Economist*. "Reforms in Mexico: Oil's Well that Ends Well," *Economist*, 14 December 2013.

<sup>2</sup> The text of the Agreement Between the United States of America and the United Mexican States Concerning Transboundary Hydrocarbon Reservoirs in the Gulf of Mexico signed in Los Cabos on 20 February 2012, can be found on the Bureau of Ocean Energy Management (BOEM) Web site.

<sup>3</sup> The complete text of the energy reform in Spanish can be found on the Web page of the Office of the President of Mexico.

<sup>4</sup> See "Statement by NSC Spokesperson Caitlin Hayden on the U.S.-Mexico Transboundary Hydrocarbons Agreement." White House press release, 19 December 2013.

<sup>5</sup> For a complete study of the international legal sources of the rights of both countries, see Garcia Sanchez, Guillermo. *La Explotacion de Recursos Trasnfornterizos en el Golfo de Mexico*. Tesis Licenciatura, ITAM, 2009; see also Wood, Duncan. *US-Mexico Cross Border Energy Cooperation: A New Era in the Gulf of Mexico*. The Wilson Center Mexico Institute, March 2012.

<sup>6</sup> Hurwitz, Ken. "US-Mexico Offshore Agreement Holds Promise but Faces Challenges," *Offshore*, 22 January 2014.

<sup>7</sup> "Treaty Between the United States of America and Mexico for the Utilization of Waters of the Colorado and Tijuana Rivers and of the Rio Grande. Signed At Washington, February 3, 1944. Treaty Series 994."

<sup>8</sup> For more information on the commission, see the International Boundary and Water Commission (IBWC) Web site.

<sup>9</sup> For a complete list of the international investment treaties, see the Web site of the Secretaria de Economia de Mexico.

<sup>10</sup> See, in general, Dolzer, Rudolf, and Christopher Schreuer. *Principles of International Investment Law*. Oxford University Press, 2008.

<sup>11</sup> For a complete list of the cases, see the Web site of the Secretaria de Economia de Mexico.

<sup>12</sup> Dolzer and Schreuer, *Principles of International Investment Law*.

<sup>13</sup> See, for example, *Repsol YPF Ecuador, S.A. and Others v. Republic of Ecuador and Empresa Estatal Petróleos del Ecuador (PetroEcuador)* (ICSID Case No.

ARB/08/10); *Burlington Resources, Inc. v. Republic of Ecuador* (ICSID Case No. ARB/08/5).

<sup>14</sup> *ConocoPhillips Petrozuata B.V., ConocoPhillips Hamaca B.V., and ConocoPhillips Gulf of Paria B.V. v. Bolivarian Republic of Venezuela* (ICSID Case No. ARB/07/30).