Mexican Energy Reform and NAFTA Chapter 11:

Looks Like Trouble to Me

Short title: Mexican Energy Reform

Abstract

Mexican energy reforms open the energy sector to foreign participation via different types of contracts, some of which may qualify as investments under NAFTA Chapter 11. Mexican NAFTA reservations exclude some Mexican regulation from the scope of application of specific obligations in Chapter 11, such as those regarding performance requirements, most-favored-nation treatment, and national treatment. However, Mexico’s legislative restrictions on foreign investors’ right to pursue investor-state arbitration are not covered by its NAFTA reservations and should not affect access to NAFTA Chapter 11 dispute settlement. Those restrictions are inconsistent with NAFTA Chapter 11 and Mexico cannot invoke its domestic laws to justify a violation of its international obligations. Moreover, Mexico’s reservations do not prevent the application of obligations regarding fair and equitable treatment and expropriation.

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1. Introduction

In December 2013, Mexico amended its constitution to allow more foreign participation in the oil sector.¹ These reforms were implemented in a series of laws passed in 2014.² In

¹ Decreto por el que se reforman y adicionan diversas disposiciones de la Constitución Política de los Estados Unidos Mexicanos, en Materia de Energía (Decree reforming and adding various

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provisions to the Political Constitution of the United Mexican States), DOF (Edición Vespertina), 2 (20 de diciembre de 2013).

2 Decreto por el que se expide la Ley de Hidrocarburos y se reforman diversas disposiciones de la Ley de Inversión Extranjera, Ley Minera, y Ley de Asociaciones Público Privadas (Decree promulgating the Hydrocarbons Law and reforming various provisions of the Foreign Investment Law, Mining Law, and Law of Public-Private Associations) (‘Hydrocarbons Law’), DOF: 11/08/2014; Decreto por el que se expide la Ley de Ingresos sobre Hidrocarburos, se reforman, adicionan y derogan diversas disposiciones de la Ley Federal de Derechos y de la Ley de Coordinación Fiscal y se expide la Ley del Fondo Mexicano del Petróleo para la Estabilización y el Desarrollo (Decree promulgating the Hydrocarbons Income Law and reforming, adding and derogating various provisions of the Federal Rights Law and the Fiscal Coordination Law y promulgating the Mexican Petroleum Fund for Stabilization and Development Law), DOF: 11/08/2014; Decreto por el que se reforman, adicionan y derogan diversas disposiciones de la Ley Federal de Presupuesto y Responsabilidad Hacendaria y de la Ley General de Deuda Pública (Decree reforming, adding and derogating various provisions of the Federal Budget and Fiscal Responsibility Law y of the General Law of Public Debt), DOF: 11/08/2014; Decreto por el que se expiden la Ley de la Industria Eléctrica, la Ley de Energía Geotérmica y se adicionan y reforman diversas disposiciones de la Ley de Aguas Nacionales Desarrollo (Decree promulgating the Electrical Industry Law, The Geothermal Energy Law and reforming, adding and derogating various provisions of the National Water Development Law), DOF: 11/08/2014; Decreto por el que se expide la Ley de los Órganos Reguladores Coordinados en Materia Energética; se reforman, adicionan y derogan diversas disposiciones de la Ley Orgánica de la Administración Pública Federal y, se expide la Ley de la Agencia Nacional de Seguridad Industrial y de Protección al Medio Ambiente del Sector Hidrocarburos Desarrollo (Decree promulgating the Coordinated Regulatory Organs in Energy Matters Law; reforming, adding and derogating various provisions of
additional, in 2012 Mexico and the United States signed the Agreement between the United States of America and the United Mexican States Concerning Transboundary Hydrocarbon Reservoirs in the Gulf of Mexico, which governs the deep-water transboundary deposits in the Gulf of Mexico and entered into force in 2014.³ These two regimes govern Mexican oil

and gas exploration and production: one for deep-water transboundary deposits in the Gulf of Mexico and one for other deposits in Mexican territory.

Mexico’s new Hydrocarbons Law permits foreign participation via different types of contracts. However, this law provides for rescission of these contracts without compensation and excludes the resulting disputes from arbitration. This article argues that foreign investors still have access to Investor-State dispute settlement in Chapter 11 of the North American Free Trade Agreement (NAFTA). However, Mexico’s measures could still fall outside the scope of application of Chapter 11 or specific obligations.

There are four ways to save investment-related measures from violating NAFTA Chapter 11: (1) by finding that the measure does not fall within the scope of application of the treaty as a whole; (2) by finding that the measure does not fall within the scope of application of a specific obligation; (3) by finding that the relevant treaty obligation has not been violated; or (4) by justifying a violation of an obligation under an exception. The burden of proof rests with the complainant to show that the treaty and obligation apply and that an obligation is violated, whereas it rests with the defending State to demonstrate compliance with an exception.\(^4\)


This article is organized as follows. First, it provides an overview of Mexico’s energy reforms. Second, it analyzes the general scope of application of NAFTA Chapter 11. Third, it analyzes Mexico’s NAFTA reservations. Fourth, it analyzes specific obligations regarding fair and equitable treatment and expropriation in light of the litigation risks posed by some of the reforms. Fifth, it analyzes the environmental exception in Article 1114.

II. Mexico’s Constitutional, Legislative and International Reforms

The Mexican energy reforms include constitutional provisions, implementing legislation, and treaty provisions in the US-Mexico Transboundary Agreement. NAFTA Chapter 11 is also relevant to the interpretation and application of these reforms. In Mexico, once the executive enters into treaties and they have Senate approval, they have direct effect and form part of Mexican law. Mexican constitutional law also establishes a hierarchy of sources of law. This hierarchy places most treaties below the Constitution (the exception being for human rights treaties), but above ordinary federal and state legislation.6 Mexican rules of constitutional and legislative interpretation resemble those of public international law in Articles 31 and 32 of the Vienna Convention on the Law of Treaties (VCLT). The

Mexican rules include: textual interpretation; contextual interpretation; object and purpose; evolutive interpretation; original intention of the drafters; legislative history; and transitional provisions. This means that foreign investors could challenge Mexican measures in domestic courts or Investor-State dispute settlement; the same network of laws would be relevant, but there would be differences in their interpretation and application. Once an investor has made its claim before a Mexican court or administrative tribunal, it is barred from pursuing its claim in NAFTA Chapter 11.

Articles 27.4 and 27.7 of the Mexican Constitution govern the exploration and extraction of petroleum and other hydrocarbons. Article 27.4 gives the Nation ‘direct possession’ of all natural resources of the continental shelf and submarine insular shelves and over petroleum and all solid, liquid or gaseous hydrocarbons. In accordance with Article 27.7, the Nation’s property rights with respect to petroleum and all solid, liquid or gaseous hydrocarbons are ‘inalienable’ and ‘imprescriptible’. The granting of concessions is prohibited. However, the Nation will carry out exploration and extraction of petroleum and other hydrocarbons via allocations (‘asignaciones’) to State enterprises or via contracts with State enterprises or the private sector (‘particulares’). State enterprises may enter into

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8 NAFTA, Annex 1120.1, Submission of a Claim to Arbitration (Mexico).
contracts with the private sector in order to realize the objective of these allocations or contracts. In any case, the hydrocarbons in the subsoil are the property of the Nation, which the allocations or contracts must affirm.

There are a few things to note about Articles 27.4 and 27.7. First, the property rights of the Nation relate to petroleum and other hydrocarbons in the subsoil, the continental shelf and submarine insular shelves. Second, the only activities covered are exploration and extraction. Article 27.6 refers to exploitation, use and enjoyment of resources via concessions in the cases referred to in Article 27.4. Article 27.7 excludes the use of concessions in the exploration and extraction of petroleum and other hydrocarbons. Articles 27.6 and 27.7 are silent regarding the participation of the private sector in other activities related to petroleum and other hydrocarbons, such as refining and distribution. The new Hydrocarbons Law regulates a far greater array of activities, including refining, transportation, storage, sale, and distribution. Changes to the regulation of these other activities would not require a constitutional amendment.

In contrast to Constitution Article 27.7, which allows exploration and extraction contracts with the private sector (‘particulares’) without restricting the legal nature of the private sector contractors, the Hydrocarbons Law only allows three types of exploration and extraction contractors: Pemex, another Mexican State enterprise, or a corporation constituted in accordance with Mexican legislation (‘persona moral’). The definition of ‘persona moral’ does not restrict the nationality of the investors who constitute the corporation or the percentage of the capital held by foreign investors. In addition to Pemex

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9 Hydrocarbons Law, above n 2, Articles 4, 5.
or another Mexican State enterprise, any person (‘persona’) with a prior authorization or permit can carry out other activities, including reconnaissance and superficial exploration, refining, transportation, storage and commercialization. While there is no definition of the term ‘persona’, the term ‘particular’ is defined as ‘persona física’ or ‘persona moral’.

Since the term ‘persona’ is not defined or qualified, it would include both types of ‘persona’; both exist in Mexican law and the Hydrocarbons Law explicitly refers to both in the definition of ‘particular’. Thus, these activities can be carried out by a corporation constituted in accordance with Mexican legislation (‘persona moral’), whether owned in whole or in part by foreign investors or nationals, or a national or foreign private individual (‘persona física’).\(^{10}\) A foreign corporation would not qualify as a ‘persona física’, since this term refers to natural persons in Mexican law, not corporations.

Mexico’s implementing legislation created four oil and gas exploration and production contract models, including: service contracts, production-sharing, profit-sharing, and licenses.\(^{11}\) This list is not exhaustive, which leaves flexibility to employ other models, most notably the unitization agreements in the US-Mexico Transboundary Agreement.\(^{12}\) Under service contracts, producers deliver all crude produced to the state in exchange for cash from the Mexican Petroleum Fund. Licenses allow producers to take crude at the wellhead after making payments to the state. The profit-sharing contracts, production-

\(^{10}\) Hydrocarbons Law, above n 2, Articles 2, 4, 5.

\(^{11}\) Hydrocarbons Law, above n 2, Article 18.

sharing contracts, and licenses will allow producers to book reserves and reflect the potential value of the oil in their accounts.\textsuperscript{13}

Article 20 of the Hydrocarbons Law permits the Mexican Federal Executive to rescind exploration and extraction contracts and to recover the Contract Area in the event that one of a series of scenarios arise involving breach of contract or negligence: (1) unauthorized delay or suspension of activities for more than 180 days; (2) failure to comply with minimum work commitments without just cause; (3) unauthorized relinquishing of the operation or contractual rights; (4) serious accidents that damage the installations and cause fatalities and loss of production; (5) delivery of incomplete or false reports to the authorities; (6) failure to comply with judicial orders; (7) unjustified failure to make payments or deliveries of hydrocarbons to the government. This rescission obliges the contractor to transfer the Contract Area to the government without the payment of compensation.

Article 21 of the Hydrocarbons Law excludes disputes listed in Article 20 from alternative dispute settlement mechanisms, including arbitrations in accordance with the provisions of international treaties on arbitration and dispute settlement to which Mexico is a party. Article 21 further provides that, in any case, neither the National Commission of Hydrocarbons nor the contractors will submit to foreign laws and that the applicable laws in any permitted arbitrations will be federal Mexican laws. While treaties form part of Mexican law, they are not typically referred to as federal laws.

Read together, Articles 20 and 21 exclude exploration and extraction contracts from the application of NAFTA Chapter 11 dispute settlement provisions. This raises two issues: (1) whether this exclusion conflicts with the general scope provision NAFTA Chapter 11, and is therefore invalid (since municipal law cannot excuse the violation of a treaty in international law); and (2) whether this exclusion is covered by a NAFTA reservation. Since a Chapter 11 reservation is part of NAFTA, the first question must be whether NAFTA Chapter 11 applies. If it does not apply, then there is no need to determine the applicability of the reservation.

Article 3 of the Hydrocarbons Law provides that exploration and extraction of deep-water transboundary deposits may be carried out in accordance with treaties and agreements to which Mexico is a party. Currently, the only treaty that is in force for deep-water transboundary deposits is the US-Mexico Transboundary Agreement. Article 17 of the Hydrocarbons Law makes the participation of Pemex or another state enterprise mandatory in Exploration and Extraction contracts in areas in which there exists the possibility that transboundary deposits will be discovered. Once the existence of a transboundary deposit is confirmed, these will be regulated in accordance with the international treaties to which Mexico is a party. Therefore, the Hydrocarbons Law can apply in the transboundary area of the Gulf of Mexico, but must be applied in accordance with the US-Mexico Transboundary Agreement once a transboundary deposit is confirmed.

The US-Mexico Transboundary Agreement does not exclude the application of NAFTA Chapter 11. Article 25 of the US-Mexico Transboundary Agreement provides that

14 US-Mexico Transboundary Agreement, above n 3.
‘nothing in this Agreement shall affect the rights and obligations of the Parties with respect to other international agreements to which they are both party.’ The only exception is the termination of the Moratorium on Hydrocarbon Activity in the Boundary Area in the Western Gap of the Gulf of Mexico, in accordance with Article 24.\(^{15}\)

The US-Mexico Transboundary Agreement regulates the national regulators, not the exploration and production activities directly.\(^{16}\) Similarly, NAFTA Chapter 11 disciplines the actions of governments; it regulates the actions of private investors only with respect to dispute settlement procedures.\(^{17}\) The Hydrocarbons Law can apply in the transboundary area once a transboundary deposit is confirmed, but only in accordance with the US-Mexico Transboundary Agreement. Therefore, with respect to confirmed transboundary deposits, the restriction on access to international arbitration in Articles 20 and 21 of the Hydrocarbons Law does not apply to the right of foreign investors to seek arbitration under NAFTA Chapter 11.

\(^{15}\) The entry into force of the US-Mexico Transboundary Agreement ended the US-Mexico moratorium on oil and gas exploration and production within the boundary area of the continental shelf, which had been established by Article 4.1 of the Treaty between the Government of the United States of America and the Government of the United Mexican States on the Delimitation of the Continental Shelf in the Western Gulf of Mexico beyond 200 Nautical Miles, done at Washington, 9 June 2000, 2143 UNTS 417 (entered into force 17 January 2001).

\(^{16}\) In accordance with Article 1, the agreement ‘shall apply to cooperation between the Parties….’ US-Mexico Transboundary Agreement, above n 3.

\(^{17}\) In accordance with NAFTA Article 1101 (1), Chapter 11 only applies to ‘measures adopted or maintained by a Party….’
Whether the restriction in Articles 20 and 21 excludes the right of foreign investors to seek arbitration under NAFTA Chapter 11 with respect to foreign investments in this sector in the rest of Mexican territory depends on Mexico’s NAFTA reservations.

In both geographic areas, the following issues will arise: (1) whether particular governmental measure falls within the scope of NAFTA Chapter 11; (2) whether a Mexican reservation excludes the application of NAFTA Chapter 11 or its specific obligations; and (3) whether the particular measures fall within the scope of application of specific obligations. Since the reservations only apply if NAFTA Chapter 11 applies, this is the logical order of analysis.

III. Which measures fall within the general scope of NAFTA Chapter 11?

NAFTA Article 1101 limits the general scope of application of NAFTA Chapter 11 to measures relating to foreign investors and investments. This raises several issues: (1) what qualifies as a ‘measure’; (2) whether the measure is excluded from the scope of NAFTA Chapter 11; (3) what qualifies as an ‘investment’; (4) whether the foreign investor owns or controls the investment; and (5) whether the ‘measure’ has a ‘legally significant connection’ to foreign investments or investors.

A. ‘Measure’

The issue is not whether NAFTA Chapter 11 applies to the entire set of Mexican energy reforms, but rather to which aspects and applications of those reforms it does apply. This approach is consistent with WTO jurisprudence approaches to the term ‘measure’. The specific measures need to be identified; merely identifying a collection of related laws is
not sufficiently specific. However, one can also analyze a series of measures that are part of the same comprehensive policy when assessing consistency with treaty provisions. Therefore, the order of analysis is first to identify the measure and then to determine whether NAFTA Chapter 11 applies.

B. Annex III exclusion

NAFTA Article 1101(2) provides that, ‘A Party has the right to perform exclusively the economic activities set out in Annex III and to refuse to permit the establishment of investment in such activities.’ In Metalclad v Mexico, the tribunal found that once Mexico had permitted an investment and assured the investor that it met all environmental requirements, it could not invoke the exception in Article 1114(1) that permits a NAFTA party to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns. Similarly, once Mexico ceases to perform the relevant activities exclusively and permits foreign investment in the oil and gas sector, it can no longer invoke Article 1101(2) and Annex III to prevent the application of NAFTA Chapter 11 to those investments. To interpret Article 1102(2) otherwise would mean interpreting the phrase

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20 *Metalclad Corporation v United Mexican States*, NAFTA/ICSID Case No. ARB(AF)/97/1, Award (30 August 2000), para 98; *Mexico v Metalclad Corporation* 2001 BCSC 664, para 104.
‘refuse to permit’ to mean ‘revoke a permit’, which is an interpretation the words cannot bear.

C. Definition of ‘investment’

NAFTA Article 1139(h) defines ‘investment’ to include some contractual interests:

interests arising from the commitment of capital or other resources in the territory of a Party to economic activity in such territory, such as under

(i) contracts involving the presence of an investor's property in the territory of the Party, including turnkey or construction contracts, or concessions, or

(ii) contracts where remuneration depends substantially on the production, revenues or profits of an enterprise

Which of Mexico’s exploration and extraction contracts would meet this definition? Production-sharing and profit-sharing contracts could qualify as contracts where remuneration depends substantially on the production, revenues or profits. Licenses will involve the presence of an investor's property in the territory of the Mexico and production-sharing. Therefore, these types of contracts could qualify as investments according to the first part of the definition in NAFTA Article 1139(h).

Article 1139(h) excludes from the definition of ‘investment’, ‘claims to money that arise solely from commercial contracts for the sale of goods or services by a national or enterprise in the territory of a Party to an enterprise in the territory of another Party’. The scope of the term ‘sale of…services’ is unclear. Article 8 of the Hydrocarbons Law permits Pemex to asign allocations (‘asignaciones’) to another Mexican state enterprise (‘empresa
productiva del estado’), with the authorization of the Secretary of Energy. The assignee can choose to cease exploration and extraction activities and to renounce the allocation, but this requires devolution of the allocation to the Mexican government without compensation.

Article 9 of the Hydrocarbons Law limits the rights of Pemex and these other state enterprises to enter into service contracts with the private sector (‘particulares’), by restricting the form of payment under such contracts to money. These provisions could have the effect of limiting the participation of the private sector in these circumstances so as to exclude their contractual interests from the definition of ‘investment’ in NAFTA Article 1139(h).

D. Joint venture ownership and control

Another issue is whether a foreign investor can submit a claim to arbitration in the case of a joint venture between the foreign investor and a domestic firm. NAFTA Article 1117(1) permits claims by an investor of a Party on behalf of an enterprise of another Party where the investor owns or controls the enterprise directly or indirectly. In Thunderbird v Mexico, a NAFTA Chapter 11 tribunal held that this does not require legal control based on a majority of voting shares, but rather a determination of whether the foreign investor exercised de facto control over the investment. The criteria to determine de facto control include: financial interest; capacity to exercise substantial influence on the administration, operations and key decisions; technology; access to inputs, markets, capital, and knowledge; reputation; and responsibility for decision-making.21 This issue may arise with respect to exploration and extraction contractors, which can be corporations constituted in

accordance with Mexican legislation, whether owned in whole or in part by foreign investors or nationals.22

E. Connection between Measure and Investment

Measures may be excluded from the scope of application of an international investment agreement (IIA) by (1) a general scope of application provision, (2) a provision that excludes certain measures from its application, such as a clause regarding ‘essential security interests’, or (3) by characterizing the measure as legitimate regulatory action that does not give rise to any breach of the IIA substantive obligations. This section examines the first situation. The third situation is examined in the context of specific obligations, below. The literature has addressed the second situation, as well as the customary international defense of necessity, in the context of financial crises.23 Opinion is divided between two approaches in the context of financial crises: that crises are precisely when foreign investors are most in need of protection or that crises are precisely when the public interest is most endangered and a government’s right to regulate in the public interest should prevail.24 This is essentially the issue that arises more generally in investment

22 Hydrocarbons Law, above n 2, Articles 2, 4, 5.


24 Sacerdoti, above n 23, at 360.
disputes: the contest between the rights of investors and the rights of governments to regulate in the public interest. Excluding measures from the general scope of application of an IIA means that the tribunal does not have jurisdiction to apply substantive obligations or exceptions.\textsuperscript{25}

NAFTA Article 1101 limits the general scope of application of NAFTA Chapter 11 to measures ‘relating to’ foreign investors and investments. NAFTA tribunals have held that the term ‘relating to’ requires a ‘legally significant connection’ between a measure and an investor or an investment. In \textit{Pope & Talbot v Canada}, Canada contended that a measure could only relate to an investment if it was ‘primarily directed’ at that investment. The tribunal accepted Canada’s argument that it was insufficient that a measure affects an investor, but rejected the contention that the measure must be primarily directed at the investment.\textsuperscript{26} In \textit{Methanex v United States}, the tribunal noted that the WTO interpretation of the term ‘relating to’ in GATT Article XX(g) was quite different from the interpretation in the \textit{Pope & Talbot} case, which confirms the need to interpret a term in accordance with

\footnote{\textsuperscript{25} Ibid, at 368. Also see \textit{Methanex Corporation v United States}, NAFTA/UNCITRAL, Award of the Tribunal on Jurisdiction and Merits (3 August 2005), at 19–20, 22.}

\footnote{\textsuperscript{26} \textit{Pope & Talbot Inc. v Government of Canada}, NAFTA/UNCITRAL, Award in relation to Preliminary Motion by Government of Canada to dismiss the claim because it falls outside the scope and coverage of NAFTA Chapter 11 ‘measures relating to investment’ motion (2000), at 33–34.
the particular context, object and purpose.\textsuperscript{27} However, the approach of NAFTA Chapter 11 tribunals to public interest measures in Article 1101 is unpredictable.

In \textit{Methanex v United States}, California banned the use of methanol as a gasoline additive (MTBE), for environmental reasons. The tribunal held that the methanol ban was a non-discriminatory environmental measure and thus not a measure ‘relating to’ foreign investment or foreign investors under NAFTA Article 1101. The \textit{Methanex} tribunal found that Article 1101(1) requires ‘something more than the mere effect of a measure on an investor or an investment’ and that the term ‘relating to’ requires a ‘legally significant connection’ between a measure and an investor or an investment.\textsuperscript{28} The scientific and administrative record established that California acted with a view to protecting the environmental interests of its citizens, and not with the intent to harm foreign methanol producers. California ordered a careful assessment of the environmental problem and responded reasonably to independent findings that large volumes of the state’s ground and surface water had become polluted by MTBE and that preventative measures were required. Thus, on the facts of this case, there was no legally significant connection between the measures, Methanex and its investments. As such, the measures did not ‘relate to’ Methanex or its investments as required by Article 1101(1).\textsuperscript{29}

Some tribunals also have used the same test as in \textit{Methanex} to require a legally significant connection between the investor and the measure, in order to exclude claims that

\textsuperscript{27} \textit{Methanex Corporation v United States}, NAFTA/UNCITRAL, First Partial Award (7 August 2002).
\textsuperscript{28} Ibid, para 4.
\textsuperscript{29} \textit{Methanex v United States}, above n 25, at 19–20, 22.
measures in one party affected investments in a different party. However, other tribunals have not used Article 1101 to exclude environmental measures from the general scope of application of NAFTA Chapter 11. In Glamis Gold v United States, the Tribunal did not follow the Methanex approach to addressing environmental measures, instead simply finding that they did not violate substantive obligations because they did not constitute expropriation or violate the minimum standard of fair and equitable treatment.

In contrast to the Methanex case, in S. D. Myers v Canada, in which Canada introduced a ban on the export of PCBs to protect the Canadian PCB disposal industry from US competition, the Tribunal concluded that there was no legitimate environmental reason for introducing the ban. The Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and Their Disposal discourages transboundary movements of hazardous wastes and encourages the creation of domestic capacity for their disposal. However, in this case it was better, from an environmental perspective, to ship hazardous wastes from Central Canada to Ohio than to Canada’s only PCB disposal facility in Alberta, due to Ohio’s much closer proximity. The tribunal held that the requirement in Article 1101 that the import ban relate to S. D. Myers and its investment was ‘easily

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31 Glamis Gold Ltd. v United States of America, NAFTA/UNCITRAL, Award (8 June 2009).

satisfied’, because the ‘specific inspiration for the export ban’ was the prospect that S. D. Myers would carry through with its plans to expand its Canadian operations.\(^{33}\)

Excluding public interest measures in the general scope provision of NAFTA Article 1101 may not be the most appropriate approach, since public interest measures also can be addressed in the substantive obligations. Indeed, there is a limit to this approach, since the term ‘relating to’ should not be stretched in order to address issues that arise regarding non-discrimination obligations, regarding expropriation, or regarding the minimum standard of fair and equitable treatment. For example, there is an obligation to pay compensation for expropriation, even when it is for a public purpose.\(^{34}\) NAFTA Article 1110 requires that expropriation be for a public purpose. To interpret NAFTA Article 1101 to exclude public interest measures from the scope of Chapter 11 would be difficult to reconcile with this public purpose requirement. Moreover, investment tribunals have addressed public interest measures by limiting the scope of specific obligations, particularly those regarding non-discrimination, fair and equitable treatment and expropriation. The flexibility that investment tribunals have to limit the scope of these obligations obviates the need to rely on a general scope provision to preserve regulatory autonomy.


\(^{34}\) Técnicas Medioambientales Tecmed S.A. v United Mexican States, ICSID Case No. ARB (AF)/00/2, Award (9 May 2003), para 121; Compañía del Desarrollo de Santa Elena v Republic of Costa Rica ICSID Case No. ARB/96/1, Award (17 February 2000), at 192.
IV. Reservations in NAFTA Chapter 11

NAFTA sets out several reservations related to the Mexican oil and gas sector. In the *Cross-Border Trucking Services* case, the NAFTA Panel analyzed the applicable NAFTA reservation before considering whether any obligations had been violated and whether the challenged measure complied with the general exceptions.\(^{35}\) This article will follow the same approach. If there is a reservation that permits a measure to not conform to the relevant obligations, then there is no need to consider whether the measure is consistent with those obligations. If there is no such reservation, then the obligation applies, as do any relevant exceptions.

A party that invokes a reservation can request an interpretation of the NAFTA Commission, which is binding on the Tribunal. If the Commission fails to submit an interpretation within 60 days of the request, the Tribunal decides the issue.\(^ {36}\)

Article 1108(1) provides that Articles 1102, 1103, 1106 and 1107 do not apply to any existing non-conforming measure that is maintained by a Party at the federal level, as set out in its Schedule to Annex I or III. These reservations also apply to an amendment to the extent that the amendment does not decrease the conformity of the measure with those articles. Mexico has a reservation for its Constitutional restrictions on investment in the oil and gas sector. Since the energy reforms have decreased those restrictions, they have not decreased the measures’ conformity with these articles. Therefore, the reservation still

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\(^{36}\) NAFTA Article 1132.
applies to the Constitutional reforms. This class of reservations has prospective application, to the extent that it applies to a limited class of future amendments. However, this does not exclude the application of NAFTA Chapter 11 or of Articles 1105 and 1110.

NAFTA Annex I sets out two relevant national treatment reservations: (1) ‘Only Mexican nationals and Mexican enterprises with a foreigners' exclusion clause may engage in the distribution, transportation, storage, or sale of liquified petroleum gas and the installation of fixed deposits. (2) ‘Only Mexican nationals and Mexican enterprises with a foreigners' exclusion clause may acquire, establish or operate retail outlets engaged in the sale or distribution of gasoline, diesel, lubricants, oils or additives.’

Neither reservation applies to exploration and extraction contracts. Neither excludes the application of NAFTA Chapter 11 or of Articles 1105 and 1110.

An interpretative Note (‘the Note’), which precedes the Parties’ Schedules at pages I-1, I-2 and I-3 of NAFTA Annex I, provides rules and guidance for interpreting the Annex I Schedules. Articles 1108(1) (investment), and 1206(1) (cross-border trade in services) allow the NAFTA Parties to make reservations in investment and in cross-border services in Annex I. The Note explicitly confirms that the reservations in Annex I constitute existing measures (‘medidas vigentes’) that do not conform to obligations imposed by: (a) Article 1102 and 1202 (national treatment), or to (b) Article 1103 and 1203 (most-favored-nation treatment).

The title of Annex I indicates that these reservations do not have prospective application: ‘Reservations for Existing Measures and Liberalization Commitments’


There is a discrepancy between the Spanish text and the English and French texts, insofar as the English text uses the term ‘existing’ in both places, as does the French text (‘existantes’) whereas the Spanish text uses the term ‘existing’ in the title of Annex I and ‘in force’ in paragraph 1. However, this discrepancy is not relevant to determining whether the reservation applies to Mexico’s energy reforms, since these reforms were neither existing nor in force at the time that NAFTA entered into force.

Article 2(f) of the Note refers to: ‘Measures identify the laws, regulations or other measures, as qualified, where indicated, by the Description element, for which the reservation is taken. A measure cited in the Measures element (i) means the measure as amended, continued or renewed as of the date of entry into force of this Agreement, and (ii) includes any subordinate measure adopted or maintained under the authority of and consistent with the measure’. Taken together, these provisions indicate that the Annex I reservations do not apply to measures that take effect after the entry in force of the NAFTA. Amendments to measures identified in the reservations would not constitute existing measures and would not be covered by the reservation. Therefore, these reservations do not apply to the Mexican constitutional reforms or to the implementing legislation, including the Hydrocarbons Law.

Article 1108(3) provides that Articles 1102, 1103, 1106 and 1107 do not apply to any measure that a Party adopts or maintains with respect to sectors, subsectors or activities, as set out in its Schedule to Annex II. Unlike Annex I reservations, this class of reservations applies to both existing and future measures. NAFTA Annex II sets out a

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39 Ibid, para 236.
reservation regarding most-favored-nation treatment (Article 1203) and local presence (Article 1205) for cross-border services: ‘Subject to Annex 602.3, Mexico reserves the right to adopt or maintain any measure related to services associated with energy and basic petrochemical goods.’ While this may permit Mexico to provide more favorable treatment to US service providers than to Canadian service providers, for example under the US-Mexico Transboundary Agreement, it does not exclude these measures from the general scope of application of NAFTA Chapter 11 or from the application of Articles 1105 and 1110.

Article 1108(4) provides that no Party may, under any measure adopted after the date of entry into force of the Agreement and covered by its Schedule to Annex II, require an investor of another Party, by reason of its nationality, to sell or otherwise dispose of an investment existing at the time the measure becomes effective. This does not exclude these measures from the general scope of application of NAFTA Chapter 11 and could become relevant in the future.

Article 1108(7) provides that Articles 1102, 1103 and 1107 do not apply to procurement by a Party or a state enterprise or subsidies or grants provided by a Party or a state enterprise. Article 1108(8)(b) provides that Article 1106(1)(b), (c), (f) and (g), and (3)(a) and (b) do not apply to procurement by a Party or a state enterprise. These reservations provide exemptions for the national content procurement requirements in Article 46 of the Hydrocarbons Law, including with respect to technology transfer. However, this does not exclude these measures from the general scope of application of NAFTA Chapter 11 or from the application of Articles 1105 and 1110.
NAFTA Chapter 6 regulates trade in energy and basic petrochemicals. Its annexes exclude much of its application to Mexico. NAFTA Annex 602.3(1) sets out a general reservation for investment and provision of services in strategic activities, including: exploration and exploitation of crude oil and natural gas; refining or processing of crude oil and natural gas; production of artificial gas, basic petrochemicals and their feedstocks and pipelines; foreign trade, transportation, storage and distribution of crude oil, natural and artificial gas, goods obtained from the refining or processing of crude oil and natural gas, and basic petrochemicals. NAFTA Annex 602.3(2) excludes private investment in these same activities and pursuant to NAFTA Article 1101(2). Mexico’s reforms appear to be consistent with these provisions, since they rely on contracts rather than foreign direct investment. However, some of these contracts qualify as investments under NAFTA Article 1139. Moreover, Annex 602.3 does not exclude the Mexican regulation of these investments from the scope of application of NAFTA Chapter 11.

Article 1101(2) gives a Party the right to perform these activities exclusively and to refuse to permit the establishment of investment in such activities. However, Mexico has waived this right implicitly with the enactment of its energy reforms, which have ended the state monopoly of Pemex and now permits foreign investment. In accordance with Article 1101(1), measures relating to investors and investments of the other NAFTA parties are within the scope of application of NAFTA Chapter 11. The arbitration exclusion in Articles 20 and 21 of the Hydrocarbons Law would not exclude such measures from Investor-State arbitration under NAFTA Chapter 11, since a state cannot invoke its domestic law to excuse the violation of its international treaty obligations.
NAFTA Annex III sets out activities reserved to the State. With respect to petroleum, other hydrocarbons and basic petrochemicals, Mexico reserves the right to perform exclusively, and to refuse to permit the establishment of investments in, inter alia, the following activities: (1) exploration and exploitation of crude oil and natural gas; refining or processing of crude oil and natural gas; and production of artificial gas, basic petrochemicals and their feedstocks and pipelines; and (2) foreign trade; transportation, storage and distribution up to and including first hand sales of the following goods: crude oil; natural and artificial gas; goods covered by Chapter Six (Energy and Basic Petrochemicals) obtained from the refining or processing of crude oil and natural gas; and basic petrochemicals. As with Annex 602.3, Mexico has waived this right implicitly with the enactment of its energy reforms. Moreover, the measures listed in the reservation have been superseded by Mexico’s Constitutional amendment and the accompanying legislation. This reservation does not exclude these measures from the scope of application of NAFTA Chapter 11.

This reservation also anticipates deregulation of activities reserved to the State:

‘Where Mexico allows private investment to participate in such activities through service contracts, concessions, lending arrangements or any other type of contractual arrangement, such participation shall not be construed to affect the State's reservation of those activities.’

Since the reservation does not exclude the Mexican regulation of these investments from the scope of application of NAFTA Chapter 11, this provision does not change the conclusion regarding the applicability of Chapter 11. The reservation permits regulation

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40 NAFTA, Annex III.A, Mexico, III-M-1.
that is inconsistent with national treatment. However, this does not exclude such regulation from the scope of application of other obligations, including Articles 1105 and 1110.

If a State has the right to maintain a monopoly, in accordance with an exemption or reservation, but then chooses to end the monopoly, it is logical to conclude that the exemption or reservation does not apply to the legislative reforms that implement this policy choice. Reservations to treaty obligations are construed restrictively.

V. Measures can still be outside the scope of a specific obligation

Mexican reservations do not exclude the application of NAFTA Chapter 11. They do not exclude the application of Article 1105 regarding fair and equitable treatment or Article 1110 regarding expropriation. Nevertheless, a measure could still be beyond the scope of application of these obligations. If the treaty applies, the reservation does not apply, and the measure falls within the scope of application of the specific obligation, then one must analyze whether the measure violates the specific obligation.

In Waste Management Inc. v Mexico, the NAFTA tribunal found that a breach of contract for services, in the form of a municipality’s failure to pay debts and failure to provide land promised under the contract, did not constitute a violation of the minimum

41 NAFTA, Annex III.B(1), (2), Mexico, III-M-1.

standard of treatment or an expropriation, since these obligations were not meant to address such contractual claims.\textsuperscript{43} This view is consistent with the definition of ‘investment’ in NAFTA Article 1139(h), which excludes ‘claims to money that arise solely from commercial contracts for the sale of goods or services’. However, in \textit{Arif v Moldova}, the tribunal held that Moldova violated the fair and equitable treatment obligation, partly based on a contract. The Complainant made his investment in reliance on a legitimate expectation of a secure legal framework for his investment in a duty-free store at an airport, based on a contract entered with a state entity, approval of the contract by a regulatory authority, and an updated license.\textsuperscript{44}

NAFTA Article 1105 requires host governments to treat foreign investors and investments in accordance with the minimum standard of treatment in customary international law.\textsuperscript{45} The claimant bears the burden of proof to establish what customary international law requires in the minimum standard of treatment.\textsuperscript{46} Moreover, the claimant bears the burden of proof to establish a violation of the minimum standard of treatment, and in particular to prove that government regulation is not a normal part of regulatory

\begin{footnotesize}
\begin{enumerate}[\itemindent=0.5cm]
\item Waste Management Inc. \textit{v} Mexico, NAFTA/ICSID Case N° ARB(AF)/ 00/3, Award (30 April 2004), para 114.
\item Mr. Franck Charles Arif \textit{v} Republic of Moldova, ICSID Case No. ARB/11/23, Award (8 April 2013), para 541.
\item Glamis Gold Ltd. \textit{v} United States, above n 31, paras 601–2.
\end{enumerate}
\end{footnotesize}
evolution that is part of the commercial risk assumed by the investor. The claimant also bears the burden of proof to establish that general regulatory changes amount to expropriation. States have a right to regulate and, as a general rule, the adverse effect of general regulation on investors is not compensable, because it does not amount to expropriation. Customary international law is also a source of defenses that can avoid the violation of IIAs by precluding wrongfulness, in which the burden of proof is on the party invoking the defense.

A. Minimum Standard in Customary International Law

Several NAFTA Chapter 11 tribunals have analyzed the customary international law standard in Article 1105. The customary international law standard does not permit resort to other treaties of the NAFTA Parties or other provisions within NAFTA. Customary international law is based on State practice, judicial or arbitral case law or other sources of customary or general international law. However, arbitral awards cannot create or prove customary international law. In particular, arbitral awards based on autonomous treaty

47 Chemtura Corporation (formerly Crompton Corporation) v Government of Canada, UNCITRAL, Award (2 August 2010), para 137; Viñuales, above n 30, at 312, 375.
48 Viñuales, above n 30, at 305–7.
49 Viñuales, above n 30, at 381–87; Sacerdoti, above n 23; van Aaken and Kurtz, above n 23; Kurtz, above n 23.
50 Mondev International Ltd. v United States, NAFTA/ICSID Case No. ARB(AF)/99/2, Award (11 October 2002), paras 120–21.
51 ADF Group Inc. v United States, NAFTA/ICSID Case No. ARB(AF)/00/1, Award (9 January 2003), para 184.
standards are not relevant in determining the customary international law standard of NAFTA Article 1105.\textsuperscript{52} In \textit{Loewen v United States}, the Tribunal observed: ‘Manifest injustice in the sense of a lack of due process leading to an outcome which offends a sense of judicial propriety is enough’.\textsuperscript{53} The Tribunal in \textit{Waste Management v Mexico} attempted to synthesize the post-interpretation jurisprudence of Article 1105, as: ‘[T]he minimum standard of treatment of fair and equitable treatment is infringed by conduct attributable to the State and harmful to the claimant if the conduct is arbitrary, grossly unfair, unjust or idiosyncratic, is discriminatory and exposes the claimant to sectional or racial prejudice, 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 any administrative process.’\textsuperscript{54}

The \textit{Methanex} tribunal found that Article 1105(1) does not preclude governmental differentiations between nationals and aliens; Article 1105(1) does not refer to discrimination, whereas Article 1105(2) does. The NAFTA Commission interpretation confirms this: ‘A determination that there has been a breach of another provision of the NAFTA, or of a separate international agreement, does not establish that there has been a

\textsuperscript{52} \textit{Glamis Gold v United States}, above n 31, paras 605-609. Also see \textit{Tecmed v Mexico}, above n 34, para 155.

\textsuperscript{53} \textit{The Loewen Group, Inc. and Raymond L. Loewen v United States}, NAFTA/ICSID Case No. ARB(AF)/98/3, Decision on Hearing of Respondent’s Objection to Competence and Jurisdiction (5 January 2001), para 132.

\textsuperscript{54} \textit{Methanex v United States} (2005), above n 25, IV.C.11-12.
breach of Article 1105(1)’. The Methanex tribunal concluded that, in the absence of a contrary rule of international law binding on the States parties, whether of conventional or customary origin, a State may differentiate in its treatment of nationals and aliens.\textsuperscript{56}

In Mobil Investments Canada Inc. & Murphy Oil Corporation \textit{v} Canada, after reviewing the NAFTA jurisprudence on Article 1105, the Tribunal summarized the standard of treatment as follows:

(1) the minimum standard of treatment guaranteed by Article 1105 is that which is reflected in customary international law on the treatment of aliens;

(2) the fair and equitable treatment standard in customary international law will be infringed by conduct attributable to a NAFTA Party and harmful to a claimant that is arbitrary, grossly unfair, unjust or idiosyncratic, or is discriminatory and exposes a claimant to sectional or racial prejudice, or involves a lack of due process leading to an outcome which offends judicial propriety.

(3) in determining whether that standard has been violated it will be a relevant factor if the treatment is made against the background of

(i) clear and explicit representations made by or attributable to the NAFTA host State in order to induce the investment, and

\textsuperscript{55} NAFTA Free Trade Commission, above, n 47.

\textsuperscript{56} Methanex \textit{v} United States (2005), above n 25, paras 14, 17, 25.
(ii) were, by reference to an objective standard, reasonably relied on by the investor, and

(iii) were subsequently repudiated by the NAFTA host State.\(^57\)

Article 1105 does not prevent a public authority from changing the regulatory environment to take account of new policies and needs, even if some of those changes may have far-reaching consequences and effects, and even if they impose significant additional burdens on an investor. The rules of customary international law only protect against egregious behavior and do not require a legal and business environment to be ‘set in concrete’\(^58\). In this case, to establish a breach of Article 1105, the Claimants had to establish that (1) clear and explicit representations were made by or attributable to Canada in order to induce the investment, (2) such representations were reasonably relied upon by the Claimants, and (3) these representations were subsequently repudiated by Canada. However, there was no evidence that Canada made representations that there would not be changes to the regulatory regime and no indication of reliance being placed upon such representations. In particular, there was no promise or representation in the underlying regulatory framework to not change an existing benefits plan or to impose a new plan.\(^59\) This case indicates that Mexico should be careful regarding the expectations that it creates in the contracts with foreign investors. However, it is not possible to generalize regarding

\(^{57}\) Mobil Investments Canada Inc. & Murphy Oil Corporation v Canada, ICSID Case No. ARB(AF)/07/4, Decision on Liability and on Principles of Quantum (22 May 2012), para 152.

\(^{58}\) Ibid, para 153.

\(^{59}\) Ibid, paras 154–59.
how a particular category of cases would be addressed, since it depends on the specific domestic regulatory framework and the surrounding circumstances of each case.

The *Mobil* tribunal’s statement of the standard in customary international law is consistent with the view that States are entitled to maintain their right to regulate, which includes the right to change the regulatory environment. The real question is whether an investor’s expectations are justifiable in the circumstances of each case. Moreover, a State may be tied to the objective expectations to the extent that it creates those expectations in order to induce investment.  

In *Arif v Moldova*, the tribunal concluded that an investor’s legitimate expectations might be breached not only by a substantive change in policy, but also by inconsistent treatment of the investor by different arms of government during the process of changing a policy.  

In the case of Mexico’s energy reforms, there is a risk of inconsistent treatment of the investor by different arms of government due to the multiplicity of government agencies and ministries that have responsibility for different aspect of oil and gas regulation. Sanctions for infractions of the Second Title of the Hydrocarbons Law, which governs exploration and extraction of hydrocarbons and covers Articles 6-47, can be as

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60 Glamis Gold v United States, above n 31, para 621.


62 See for example Hydrocarbons Law, above n 2, Articles 29–31.
high as USD 21-31 million plus the value of extracted hydrocarbons.\textsuperscript{63} Responsibility for applying sanctions is distributed among the Energy Secretary, the National Commission of Hydrocarbons, the Finance Secretary, the Economy Secretary, and the Regulatory Commission of Energy.\textsuperscript{64} The National Agency of Industrial Safety and Environmental Protection governs liability for environmental damage under a separate law.\textsuperscript{65}

How should a tribunal balance a State’s pursuit of legitimate regulatory objectives and the legitimate expectations of an investor of a secure legal framework for its investment? Voon and Mitchell argue, in the case of tobacco regulation, that public interest regulation should pass the test where (1) the State has a legitimate regulatory interest, (2) there is a rational relationship between the policy and the measure, and (3) given the public interest at stake, the investor cannot reasonably have expected that the regulatory environment would remain frozen.\textsuperscript{66}

\textsuperscript{63} Hydrocarbons Law, above n 2, Articles 47, 85. Calculations of fines are based on the minimum wage and exchange rate of 15 October 2015.
\textsuperscript{64} Hydrocarbons Law, above n 2, Article 85.
\textsuperscript{65} Hydrocarbons Law, above n 2, Article 129; Ley de la Agencia Nacional de Seguridad Industrial y de Protección al Medio Ambiente del Sector Hidrocarburos (Law of the National Agency of Industrial Safety and Environmental Protection en the Hydrocarbons Development Sector), DOF: 11/08/2014.
In Mondev v United States, the Tribunal stated that the standard of fair and equitable treatment has evolved with the development of international law since the 1920s. In Glamis Gold v United States, the Tribunal held that the minimum standard in NAFTA Article 1105 is at least the standard in Neer: ‘the treatment of an alien, in order to constitute an international delinquency, should amount to an outrage, to bad faith, to wilful neglect of duty, or to an insufficiency of governmental action so far short of international standards that every reasonable and impartial man would readily recognize its insufficiency.’ The Tribunal found that the claimant had not proved that the minimum standard of treatment had evolved beyond this 1926 standard, with the exception that a demonstration of bad faith is no longer required. However, the Tribunal found that the conduct that the international community views as falling below this standard may change over time. Thus, the fair and equitable treatment standard is subject to the evolution of the international view of what is shocking and outrageous.

B. Compensation for Expropriation

NAFTA Article 1110 requires host governments to provide compensation for expropriation and measures that are tantamount to expropriation. It also requires that expropriations be made for a public purpose, be non-discriminatory and be in accordance with due process and Article 1105(1). Article 20 of the Hydrocarbons Law permits administrative rescission of contracts and the transfer to the Mexican government of rights to exploration and

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67 Mondev v United States, above n 50, para 116.
69 Glamis Gold v United States, above n 31, paras 612–16.
extraction blocks, without any compensation. This could be inconsistent with the compensation obligation in NAFTA Article 1110, if a specific measure falls within the scope of application.

In *S. D. Myers v Canada*, the tribunal considered that the term ‘expropriation’ in Article 1110 must be interpreted in light of the whole body of state practice, treaties and judicial interpretations of that term in international law cases. The general body of precedent usually does not treat regulatory action as amounting to expropriation, because expropriations tend to involve the deprivation of ownership rights and regulations involve a lesser interference. Moreover, an expropriation usually amounts to a lasting removal of the owner’s ability to make use of its economic rights. Administrative rescission of contracts and the transfer to the Mexican government of rights to exploration and extraction blocks do not involve ownership rights per se, since the ownership of the hydrocarbons remains with the Mexican government.

Nevertheless, international law establishes that the follows types of government actions may constitute expropriation: (1) the taking of title to property, in whole or in part; (2) the use of police, administrative or legal powers to take control of the operation of an investment, or shut the investor out of its rights of control and ownership, without the transfer of title; and (3) creeping expropriation: the use of a series of measures that cumulatively rather than individually accomplish the removal of ownership or control of an investment. A more controversial argument is that the diminution of economic value due to

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70 *S. D. Myers v Canada*, above n 33, paras 280–88.
a regulation that protects the public interest can be the basis for a finding of expropriation.\textsuperscript{71} With respect to contracts that meet the NAFTA definition of ‘investment’, administrative rescission of contracts and the transfer to the Mexican government of rights to exploration and extraction blocks would wholly deprive the investor of the investment. As such, actions taken in accordance with Article 20 of the Hydrocarbons Law could qualify as an expropriation of the investment.

However, under customary international law, where economic injury results from \textit{bona fide} regulation, compensation is not required. States are not liable to compensate aliens for economic loss incurred as a result of a nondiscriminatory action to protect the public interest.\textsuperscript{72} However, once an expropriation has taken place, compensation is due even if for a public purpose.\textsuperscript{73} NAFTA Article 1110 requires compensation expropriation, even if the taking is for a public purpose, non-discriminatory and in accordance with due

\textsuperscript{71} Howard Mann and Don McRae, International Institute for Sustainable Development, Amicus Curiae Submission, \textit{Methanex v United States} (2004), para 84

\textsuperscript{72} Ibid, para 84; Restatement of the Law Third: The Foreign Relations of the United States: A state is not responsible for loss of property or for other economic disadvantage resulting from \textit{bona fide} general taxation, regulation, forfeiture for crime, or other action of the kind that is commonly accepted as within the police powers of states, if it is non-discriminatory (cited in \textit{Marvin Roy Feldman v United Mexican States}, NAFTA/ICSID Case No. ARB(AF)/99/1, Award (16 December 2002), para 105.)

\textsuperscript{73} \textit{Santa Elena v Costa Rica}, above n 34; \textit{Metalclad v Mexico}, above n 20; \textit{Mexico v Metalclad}, above n 20, para 104.
process of law and Article 1105(1).\textsuperscript{74} However, not all government regulatory activity that makes it difficult or impossible for an investor to carry out a particular business is an expropriation under Article 1110.\textsuperscript{75} For example, in Methanex, the Tribunal concluded that the California methanol ban was a lawful regulation and not an expropriation.\textsuperscript{76} Therefore, it is possible that Mexico’s public interest regulations would fall outside the scope of application of Article 1110 and not require compensation. However, this would have to be determined on a case-by-case basis. For example, Article 47 (IX) of the Hydrocarbons Law establishes liability for wastage, oil spills, and other damages that result from failures of industrial safety and environmental protection. Depending on how this liability is assessed and how the laws are applied, such regulations could fall outside the scope of application of Article 1110.\textsuperscript{77} However, it is difficult to determine where to draw the line between non-compensable exercises of regulatory authority and exercises of regulatory authority that amount to expropriation of an investment, other than on a case-by-case basis.

The Methanex case indicates that science-based regulatory decisions are likely to withstand scrutiny in NAFTA Chapter 11.\textsuperscript{78} In that case, the science was preliminary, but

\begin{itemize}
  \item \textsuperscript{74} Marvin Feldman v Mexico, above n 72, para 98.
  \item \textsuperscript{75} Marvin Feldman v Mexico, above n 72, para 112.
  \item \textsuperscript{76} Methanex v United States (2005), above n 25, IV.D.15
  \item \textsuperscript{77} Also see Hydrocarbons Law, above n 2, Articles 129–30.
  \item \textsuperscript{78} This stands in contrast to Ethyl Corporation v Canada, a case in which the Canadian government agreed to withdraw a trade ban and publicly concede that there was no scientific basis for the ban. Sanford E. Gaines, ‘Protecting Investors, Protecting the Environment: The Unexpected Story of NAFTA Chapter 11’ in David L. Markell & John H. Knox (eds), Greening NAFTA: The North
there was sufficient scientific evidence of the potentially serious health effects of methanol to support the state regulation. The Methanex case is of particular relevance to environmental and safety regulations, since it shows that regulation based on the precautionary principle can survive a challenge by foreign investors.

VI. Limited Exceptions in NAFTA Chapter 11

In NAFTA Chapter 11, exceptions are limited. Given the Mexican reservation for the relevant provisions of Article 1106, there is no need to discuss the exceptions in Article 1106 in this article. Article 1114 supports the view that legitimate environmental regulation is beyond the scope of Chapter 11, by confirming the right of parties to protect the environment and recognizing that, far from discouraging environmental regulation, Chapter 11 discourages the relaxation of environmental regulation in order to attract investment.

Article 1114 provides as follows:

Article 1114: Environmental Measures

1. Nothing in this Chapter shall be construed to prevent a Party from adopting, maintaining or enforcing any measure otherwise consistent with this Chapter that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns.

2. The Parties recognize that it is inappropriate to encourage investment by relaxing domestic health, safety or environmental measures. Accordingly, a Party should not

waive or otherwise derogate from, or offer to waive or otherwise derogate from, such measures as an encouragement for the establishment, acquisition, expansion or retention in its territory of an investment of an investor. If a Party considers that another Party has offered such an encouragement, it may request consultations with the other Party and the two Parties shall consult with a view to avoiding any such encouragement.

In *Metalclad v Mexico*, Metalclad invested in a hazardous waste plant. The Mexican state of San Luis Potosi declared the area where the plant was located to be an ecological zone, which prevented Metalclad from operating the plant. Both the NAFTA tribunal and the British Columbia Supreme Court held that this ecological decree was a measure equivalent to expropriation that required Mexico to pay compensation. Mexico raised Article 1114(1) as a defense. The tribunal rejected this argument because Mexico had satisfied itself that Metalclad’s investment would be undertaken in a manner consistent with environmental concerns, through an agreement with Metalclad and federal permits.\(^79\) On judicial review to the British Columbia Supreme Court, the Court held that this conclusion was not unreasonable.\(^80\)

The ruling in *Metalclad* suggests that Article 1114(1) can only justify environmental regulations that are in force prior to an investment being made. Many existing investments could be affected by future environmental regulation. If one accepts the reasoning in *Methanex*, such post-investment regulations would not relate to investment and thus would not have to be justified under Article 1114(1).

\(^79\) *Metalclad v Mexico*, above n 20.

\(^80\) *Mexico v Metalclad*, above n 20.
NAFTA Article 1114(2) was inserted to address concerns that NAFTA would create ‘pollution havens’— the relaxation of environmental regulations in order to attract investment. This type of provision generally is not subject to arbitration and does not prevent changes to environmental regulations.\textsuperscript{81}

\textbf{VII. Conclusion}

Mexico’s energy reforms have created a complex system of national legislation, regulatory agencies, and international treaties. The interactions between these sources of law create a separate legal regime for the deep-water transboundary deposits in the Gulf of Mexico, based on activities, geographic location and the date on which the transboundary nature of a deposit is confirmed. For these deposits, the US-Mexico Transboundary Agreement and NAFTA Chapter 11 apply cumulatively. These two treaties also must be taken into account in the interpretation and application of the domestic regulatory regime. In the rest of Mexican territory, only NAFTA Chapter 11 affects the interpretation and application of the domestic regulatory regime.

The Mexican energy reforms open the energy sector to foreign participation via different types of contracts. Some of these contracts may as investments under NAFTA Chapter 11. Mexican NAFTA reservations exclude some Mexican regulation from the scope of application of specific obligations in Chapter 11, such as those regarding performance requirements, most-favored-nation treatment, and national treatment. However, Mexico’s legislative restrictions on foreign investors’ right to pursue Investor-

State arbitration are not covered by its NAFTA reservations. Those restrictions are inconsistent with NAFTA Chapter 11 and Mexico cannot invoke its domestic laws to justify a violation of its international obligations. Moreover, Mexico’s reservations do not prevent the application of the key obligations regarding fair and equitable treatment in Article 1105 and expropriation in Article 1110.

Public interest measures can still fall outside the scope of application of specific obligations. Much of Mexico’s new regulatory regime could fall into this category. However, the multiplicity of government agencies that are responsible for the new regulatory regime increases the risk of violations of the Article 1105 standard of fair and equitable treatment. Provisions in the Hydrocarbons Law that allow administrative rescission of contracts and the return of exploration and extraction blocks to the Mexican government, without compensation, could be inconsistent with the Article 1110 obligation to pay compensation for expropriation.