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Abstract

This Note will present the arguments for and against foreign direct investment, but assess the Pemex reforms under the assumption that reform through privatization is necessary for survival. This Note will examine the likelihood of success for the recently proposed Pemex reforms, and what the Mexican government may expect with regards to Pemex's future. Part I provides an introduction to FDI and the legal and political framework that President Calderon must work in to accomplish Pemex reforms. Part II presents two financial models for energy reform that may serve as a blueprint for Pemex: 1) Mexico's electric power deregulatory scheme, and 2) the Brazilian oil sector's gradual privatization. In light of all these considerations, Part III will outline a reform model that can be applied to Pemex's delicate political-economic status.

NOTE

THE LEGAL OBSTACLES TO FOREIGN DIRECT INVESTMENT IN MEXICO'S OIL SECTOR

Martin Miranda[*]

INTRODUCTION

On October 28, 2008, riot police in Mexico City surrounded the Senate offices to restrain protesters as Mexican lawmakers voted to increase private activity in the state-controlled oil monopoly Petróleos Mexicanos ("Pemex").[1] After years of declining oil production from Pemex, Mexican President Felipe Calderón and his conservative National Action Party ("PAN") are fighting to win public support to revive Pemex through agreements with foreign oil companies.[2] Former presidential candidate Andrés Manuel López Obrador, who narrowly lost the 2006 election by only half a percent (approximately 240,000 votes),[3] is President Calderón's harshest critic.[4] As Mexico City's

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1. *See* Ken Ellingwood, *Mexican Senate Passes Legislation to Overhaul Oil Industry*, L.A. TIMES, Oct. 24, 2008, at A4 (summarizing the political unrest leading up to the vote on the energy reform bill); *see also* Ioan Grillo, *Opening Up Mexico's Oil to Foreigners: A First Step*, TIME.COM, Oct. 31, 2008, http://www.time.com/time/world/article/0,8599,1855621,00.html?xid=rss-world (analyzing the October 2008 Petróleos Mexicanos ("Pemex") reforms).

2. *See* Ellingwood, *supra* note 1 (describing the rationale behind President Calderón's Pemex reforms); *see also* Grillo, *supra* note 1 (noting the political obstacles to Pemex reform).

3. *See* James C. McKinley Jr., *Mexican Court Rejects Election Fraud Challenges*, N.Y. TIMES, Aug. 28, 2006, at A10 (depicting the political implications of the Mexican federal court's decision not to pursue Mr. Obrador's voter fraud allegations); *see also* Hector Tobar & Sam Enriquez, *Caldrerón Moves Closer to Victory in Mexico*, L.A. TIMES, Aug. 29, 2006, at A1 (describing the severity of protests in Mexico City demanding a recount in the presidential election).

former mayor, and de facto leader of the opposition party, the Democratic Revolution Party ("PRD"), Mr. Obrador mobilized the massive street protest to thwart the President's plans, which he claims will lead to Pemex's total privatization.[5] President Calderón claims Pemex is not being privatized but strengthened.[6] The President's plan would prevent foreign direct investment ("FDI") in oil exploration activities; however, some critics believe Pemex's fate will inevitably depend on Mexico's ability to attract FDI with foreign oil companies.[7]

Mexico is the world's sixth largest petroleum producer, but its oil reserves fell by twenty-five percent from 2002 to 2007,[8] and many believe that Mexico's oil production reached its historical peak in 2004.[9] Pemex pays over sixty percent of its US$77 billion in revenue to the Mexican government through royalties and taxes, which accounts for forty percent of the federal government's annual budget.[10] This leaves Pemex with little left-

4. *See* Ellingwood, *supra* note 1 (detailing Mr. Obrador's hard-line position against the October Pemex reforms); *see also* Grillo, *supra* note 1 (discussing Mr. Obrador's calls for protest to pressure Mexican lawmakers to vote against the October Pemex legislation).

5. *See* Ellingwood, *supra* note 1 (describing the opposition party's concerns over allowing increased private activity in Mexico's oil sector); *see also* Grillo, *supra* note 1 (stating Mr. Obrador's position as a left-wing hardliner in Mexico's political arena).

6. *See* Jason Beaubien, *Change Proposed for Mexican Oil Monopoly in Crisis*, NAT'L PUB. RADIO, May 21, 2008, http://www.npr.org/templates/story/story.php?storyId=90402097 (describing the political exchanges between President Calderón and the opposition party over the President's initial proposal in the Spring of 2008); *see also* Norma Gutierrez, *Mexico: Historic Reform of Petróleos Mexicanos (PEMEX) and Approval of Renewable and Sustainable Energy Bills*, GLOBAL LEGAL MONITOR, Nov. 6, 2008, http://www.loc.gov/lawweb/servlet/lloc_news?disp3_763_text (providing President Calderón's stated intent for his Pemex reform proposal in the Spring of 2008).

7. *See* Ellingwood, *supra* note 1 (addressing the concerns of critics who believe the Pemex reforms do not go far enough to encourage foreign companies to work with Pemex); *see also* Grillo, *supra* note 1 (suggesting that Pemex's current economic status requires more substantive reforms).

8. *See* Ellingwood, *supra* note 1 (explaining Pemex's oil producing capacity); *see also* Marla Dickerson, *Woes Mount for Mexico's State Oil Titan*, L.A. TIMES, Jan. 2, 2008, at C1 (describing Pemex as leading global oil producer).

9. *See* Dickerson, *supra* note 8 (illustrating the extent of Pemex's recent decline in oil production); *see also* Elisabeth Malkin, *Mexico Proposes Limited Overhaul of State Oil Monopoly*, N.Y. TIMES, Apr. 10, 2008, at C2 (examining Pemex's future oil production estimates).

10. *See* Symposium, *Energy and International Law: Development, Litigation, and Regulation*, 36 TEX. INT'L L.J. 1, 58 (2001) (outlining the extent of the Mexican government's financial control over Pemex); *see also* Ellingwood, *supra* note 1 (illustrating the high level of taxes Pemex pays to the Mexican government).

over capital to drill for new oil and develop deep-sea exploration technologies.[11] To compound matters, there is a shortage of refineries, and Mexico must import nearly forty percent of its gasoline, which costs US$1 billion each year.[12] As of March 2007, Pemex's total consolidated debt was just over US$52 billion.[13] Pemex is Mexico's largest employer, biggest taxpayer, and a most generous provider of social services.[14] It has built housing, schools, and health clinics in some of the nation's poorest areas.[15] The decisions over Pemex's future will affect nearly every Mexican citizen.

The Mexican Constitution allows Pemex to enter into service contracts with foreign companies to perform petroleum related activities, but incentive-based performance contracts are not permitted.[16] Many experts say the only hope to save Pemex is to find new sources of oil in the Gulf of Mexico, but Pemex lacks the knowledge and expertise, and needs outside help to bring in new technology for deep-water exploration.[17] The United States, which is seeking to end its dependence on the Organization of Petroleum Exporting Countries ("OPEC"), would be an ideal

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11. *See* Thomas Black & Andres R. Martinez, *Pemex Missteps Pare Oil Revenues, Pave Way for Petrobras Entry*, BLOOMBERG, Mar. 31, 2008, http://www.bloomberg.com/apps/news?pid=20601109&refer=news&sid=a7pcyPC6LgXk (highlighting the diverging interests developing between Pemex and the Mexican government); *see also* Hector Tobar, *Calderón Seeks Overhaul of Mexico's Oil Firm*, L.A. TIMES, April 9, 2008, at A3 (stating President Calderón's belief that Mexico lacks the resources to finance its own oil sector modernization).

12. *See* Ewell E. Murphy Jr., *The Prospects for Further Energy Privatization in Mexico*, 36 TEX. INT'L L.J. 75, 80 (2001) (explaining the economic effect of Pemex's recent shortcomings); *see also* Malkin, *supra* note 9 (pointing to Mexico's lack of refineries to illustrate Pemex's poor investment strategy).

13. *See* James Crombie, *Pemex Rebuffs Critics*, LATINFINANCE, June 2007, at 5 (forecasting the likelihood Pemex will increase their debt in the future); *see also* Marla Dickerson, *Oil Find in Mexico Far From Success*, L.A. TIMES, Mar. 15, 2006, at C1 (attributing a large portion of Pemex's losses to the interest payments on their debt).

14. *See* Danielle Homant, *Mexico: Constitutional and Political Implications of the 1995 Gas Regulations*, 4 TULSA J. COMP. & INT'L L. 233, 240 (suggesting that Pemex's increasing tax burdens could affect their ability to assist poor communities); *see also* Tobar, *supra* note 11 (underscoring Pemex's pervasive role in Mexican society).

15. *See* Homant, *supra* note 14, at 240 (noting Pemex's traditional practice of providing health and education related programs to poor communities); *see also* Tobar, *supra* note 11 (listing several public works programs coordinated by Pemex).

16. *See infra* note 43 and accompanying text.

17. *See* Black & Martinez, *supra* note 11 (addressing Pemex's need to partner with foreign companies for deep water drilling technology); *see also* Tobar, *supra* note 11 (summarizing Calderón's belief that Pemex needs to partner with foreign companies to prevent further oil production decline in the future).

candidate for Mexico to seek foreign investments to discover and produce oil while helping to modernize the Mexican oil sector.[18] Instead of developing this relationship with the United States, Pemex focuses principally on its domestic market in fear of becoming too economically dependent on the United States and losing tens of billions of barrels in Mexican oil reserves.[19] With oil prices fluctuating dramatically in the wake of the 2008 world financial crisis,[20] and without new major discoveries of crude oil,[21] Pemex's financial health appears to be in serious jeopardy.

This Note will present the arguments for and against FDI, but assess the Pemex reforms under the assumption that reform through privatization is necessary for its survival. This Note will examine the likelihood of success for the recently proposed Pemex reforms, and what the Mexican government may expect with regards to Pemex's future. Part I provides an introduction to FDI and the legal and political framework that President Calderón must work in to accomplish Pemex reforms. Part II presents two financial models for energy reform that may serve as a blueprint for Pemex: (1) Mexico's electric power deregulatory scheme, and (2) the Brazilian oil sector's gradual privatization. This Part will also discuss the dangers of expropriation that

18. The Organization of Petroleum Exporting Countries ("OPEC") is comprised of Algeria, Angola, Ecuador, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, the United Arab Emirates, and Venezuela, which have all agreed to coordinate the their production and set the price of oil worldwide. *See* Murphy, *supra* note 12, at 80 (illustrating the economic potential of a relationship between Mexico and the United States in the oil sector); *see also* Cody Miller, *Petroleum Exports from Latin America to the United States*, 10 LAW & BUS. REV. AM. 819, 824, 832 (2004) (depicting Mexico as one of the largest non-OPEC oil producing countries in the world).

19. *See* Murphy, *supra* note 12, at 80 (predicting the potential losses Mexico faces by refusing to provide incentive-based contracts for foreign oil companies); *see also* Catherine Malkin, *Output Falling in Oil-Rich Mexico, and Politics Gets the Blame*, N.Y. TIMES, Mar. 9, 2007, at C3 (explaining how foreign companies with deepwater exploration technology have made discoveries in the region neighboring Pemex in the Gulf of Mexico).

20. *See The Outlook for the Oil Price: Bust and Boom*, ECONOMIST, May 21, 2009, at 71 (explaining how the volatility of oil prices are making oil companies cautious about future investments); *see also The Global Petroleum Perspective*, APS REV. OIL MARKET TRENDS, June 1, 2009, *available at* http://www.thefreelibrary.com/The+Global+Petroleum+Perspective.-a0201853331 (discussing OPEC's strategy to stabilize international oil prices).

21. *See* Ellingwood, *supra* note 1 (citing oil specialists who believe Pemex needs deep-water exploration technology to make new oil discoveries); *see also* Malkin *supra* note 19 (explaining that Pemex lacks the deepwater exploration technology to make new oil discoveries).

politically unstable countries pose to foreign investors, and how the North American Free Trade Agreement ("NAFTA") may help to mitigate those risks. In light of all these considerations, Part III will outline a reform model that can be applied to Pemex's delicate political-economic status. This Note then revisits the legal and political obstacles that stand in the President's way, and provides an outlook on the potential consequences of oil reform in Mexico. Finally, this Note argues that, if the Mexican government wants long-term sustainable revenue from Pemex in the future, it must allow foreign companies to either renovate Pemex's facilities through concession contracts, or produce oil on their own account under a restructured Mexican regulatory regime.

I. *LEGAL AND POLITICAL FRAMEWORK OF PEMEX AND MEXICO'S ENERGY SECTOR*

This Part begins by outlining the prospects and pitfalls of FDI. It also describes the views held by oil-producing Latin American countries towards FDI, and then explains the development of the constitutional provisions governing Mexico's oil sector. This Part concludes by outlining President Calderón's initial reform proposal and its subsequent revisions in order to pass congress.

A. *Foreign Direct Investment in the Latin American Oil Sector*

Foreign direct investment is generally defined as the transfer of assets from one country to another in order to generate wealth for the owner of those assets.[22] While FDI faces tough opposition in a number of countries, it allows underdeveloped nations to seek capital outside their borders to modernize their infrastructure and introduce new technology, which in turn creates a larger tax base to expand public services and provide valuable training to local industries.[23] On the other hand, FDI

22. *See* PAUL E. COMEAUX & N. STEPHAN KINSELLA, PROTECTING FOREIGN INVESTMENT UNDER INTERNATIONAL LAW: LEGAL ASPECTS OF POLITICAL RISK, at xix-xx (1997) (defining Foreign Direct Investment ("FDI") and explaining its characteristics); *see also* M. SORNARAJAH, THE INTERNATIONAL LAW ON FOREIGN INVESTMENT 4 (2004) (introducing the general characteristics of FDI).

23. *See* COMEAUX & KINSELLA, *supra* note 22, at xix-xx (discussing the interaction between international law, and the political risk to foreign investments); *see also* Joshua

can create incentives for corruption, overwhelm local competitors in their own markets, and encroach on a host government's ability to respond to economic crisis.[24] History has shown this double-edged sword as cutting in both directions. In the 1980s, FDI helped boost the "Four Asian Tiger" economies, but also contributed to political instability in many Latin American countries as they defaulted on their escalating debts.[25]

For this reason, some of the strongest opposition to FDI resonates in Latin America, especially over oil, one of the world's most lucrative and depleted resources. In 2006, Bolivian President Evo Morales sent soldiers to foreign-owned oil facilities and threatened to expropriate them unless they renegotiated their contracts to surrender control over the chain of production.[26] Venezuela also took steps to place oil properties under government control by raising taxes on foreign-owned companies that had entered into lease agreements with the prior government.[27] Forced contract modifications are not exclusive to leftist regimes in Latin America, and most oil resources are based on some form of state ownership.[28] For example, in 2006 the U.S. House of Representatives voted in favor of renegotiating for

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Robbins, *The Emergence of Positive Obligation in Bilateral Investment Treaties*, 13 U. MIAMI INT'L & COMP L. REV. 403, 408 (2006) (describing some of the benefits to FDI).

24. *See* Alejandro Posadas, *Combating Corruption Under International Law*, 10 DUKE J. COMP. & INT'L L. 345, 414 n.301 (2000) (explaining the potentiality for government corruption by a host country receiving FDI); *see also* Kenneth J. Vandevelde, *The Economics of Bilateral Investment Treaties*, 41 HARV. INT'L L.J. 469, 481-84 (2000) (discussing the effects of foreign investment on a host country's economy).

25. The Four Asian Tigers refer to the economies of Hong Kong, Singapore, South Korea, and Taiwan. These countries enjoyed rapid industrialization and high growth rates from the 1960s to the 1990s. *See* Toyoo Gyohten, *The Global Capital Market: What Next: East Asian Capital Markets*, 21 FORDHAM INT'L L.J. 371, 371 (1997) (highlighting the East Asian economies that experienced rapid growth beginning in the 1970s); *see also* Kenneth J. Vandevelde, *A Brief History of International Investment Agreements*, 12 U.C. DAVIS J. INT'L L. & POL'Y 157, 177 (2005) (referring to the success of the East Asian economies to demonstrate the benefits of FDI).

26. *See* Paulo Prada, *Bolivian Nationalizes the Oil and Gas Sector*, N.Y. TIMES, May 2, 2006, at A9 (presenting President Morales' oil nationalization policy); *see also* Patrick J. McDonnell, *Bolivian Leader Nationalizes Fuel Industry*, L.A. TIMES, May 2, 2006, at A21 (surveying the international reaction to Bolivia's oil nationalization plan).

27. *See infra* Part II.C.

28. *See* Peter Charles Coharis, *U.S. Courts and the International Law of Expropriation: Toward a New Model for Breach of Contract*, 80 S. CAL. L. REV. 1, 2 (2006) (noting that government regulation in the oil sector is common); *see also, e.g.*, Edmund L. Andrews, *Vote in House Seeks to Erase Oil Windfall*, N.Y. TIMES, May 19, 2006, at A1 (citing an example of U.S. government regulation over domestic oil reserves).

higher royalties from oil companies drilling in U.S. territory in the Gulf of Mexico.[29] The bill passed 252-165, including sixty-seven Republicans voting in favor of the bill.[30]

While Pemex remains a vital source of revenue for the Mexican government and powerful symbol of Mexican sovereignty, the opposition to foreign investment and private activity is leaving the oil sector with an aging infrastructure and declining production.[31] President Calderón's initial proposal would have allowed Pemex to create risk-contracts with foreign companies to provide their drilling and exploration expertise to help offset declining oil production.[32] Facing strong opposition, President Calderón rescinded the controversial measure, instead promising to revive Pemex through gradual reform to avoid a constitutional challenge in the courts.[33]

The Mexican people have reason to distrust private investors seeking access to Mexico's nationalized industries. The Mexican government previously mishandled the nation's bank privatization, allegedly riddled with backroom deals, which cost Mexican taxpayers an estimated US$65 billion.[34] Charges of corruption and crony capitalism are prevalent throughout Mexico's history, from the pre-revolutionary corruption of the

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29. *See* Coharis, *supra* note 28, at 2 (using the U.S. as an example of an industrialized Western country increasing government regulation in their oil sector); *see also* Andrews, *supra* note 28 (explaining the politics behind the U.S. Congress's vote and the oil companies' reaction).

30. *See* Coharis, *supra* note 28, at 2 (reporting the voting results of the U.S. Congress's decision to renegotiate for higher royalties in the oil sector); *see also* Andrews, *supra* note 28 (reporting on the U.S. Congress's vote to increase royalties).

31. *See* Murphy, *supra* note 12, at 81 (stating that Pemex's recent economic challenges stem from its inadequate infrastructure); *see also* Black & Martinez, supra note 11 (illustrating the negative effects of Pemex's tax obligations).

32. *See* Beaubien, *supra* note 6 (summarizing the desired effects of President Calderón's initial proposal); *see also* Tobar, *supra* note 11 (outlining President Calderón's initial goals for Pemex reforms).

33. *See* Grillo, *supra* note 1 (explaining that Calderón's final reform bill disappointed foreign oil companies' expectations); *see also* Gutierrez, *supra* note 6 (outlining the final provisions of the energy reform bill).

34. *See* James A. Dement Jr., *Production and Distribution of Electric Power in Mexico: Today and Tomorrow,* 8 U.S.-MEX. L.J. 43, 46 (2000) (discussing the National Action Party's criticism of the Institutional Revolution Party's ("PRI") missteps in implementing prior privatization plans towards nationalized industries); *see also* Marla Dickerson, *Mexico's Stubborn Lack of Choices,* L.A. TIMES, Apr. 16, 2006, at C1 (explaining how Mexico's policies have led to the prevalence of oligopolies in Mexican society).

Porfirio Diaz regime,[35] to the misappropriation of Pemex funds toward campaign budgets in the 2000 presidential election.[36] Mexicans also frequently point to Carlos Slim, the Mexican businessman who made billions of dollars from the privatization of the national phone company, Teléfonos de México, as the most recent example of the Mexican government's failure to consider the larger Mexican population's interest when deregulating major industries.[37] Given the government's history of mishandling prior deregulatory schemes, President Calderón's Pemex reforms were facing an uphill battle for public support before they were even announced.

B. *Constitutional Provisions Governing Mexican Oil*

Since the end of the Mexican Revolution in 1917, oil nationalization has symbolized Mexico's national policy toward economic development as government leaders gradually reduced foreign activity in Mexico's natural resources.[38] Disagreements over labor and tax laws prompted Mexican President Lázaro Cárdenas[39] to expropriate all foreign-owned oil companies to create Pemex in 1938.[40] Since 1938, only Pemex, under direct control of the Mexican government, is permitted to produce Mexico's oil.[41]

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35. President from 1876 to 1880 and 1884 to 1911. *See* MICHAEL S. WERNER, CONCISE ENCYCLOPEDIA OF MEXICO 166 (2001).

36. *See* Patrick Del Duca, *The Rule of Law: Mexico's Approach to Expropriation Disputes in the Face of Investment Globalization*, 51 UCLA L. REV. 35, 46-47 (2003) (observing the political cronyism prevalent throughout Mexico's history); *see also* Richard Bourdeax, *Fox Targets Graft in Mexico Monopoly*, L.A. TIMES, Sept. 28, 2002, at A1 (detailing the difficulties that former President Fox faced during his campaign to challenge the PRI's corrupt ties to the oil sector and trade unions).

37. Beaubien, *supra* note 6 (describing Mr. Slim's large profits from the privatization deal); *see also* Luisa Kroll, *Billionaires 2008*, FORBES, Mar. 24, 2008, at 80 (providing an annual list of the world wealthiest individuals).

38. *See* Gloria L. Sandrino, *The NAFTA Investment Chapter and Foreign Direct Investment in Mexico: A Third World Perspective*, 27 VAND. J. TRANSNAT'L L. 259, 283-87 (1994) (summarizing Mexico's role as a leading voice addressing foreign direct investment's potentially exploitative nature); *see also* Homant, *supra* note 14, at 235 (describing Mexico's post-revolutionary attitude towards foreign influence).

39. President from 1934-1940. *See* WERNER, *supra* note 35, at 64.

40. *See* Homant, *supra* note 14, at 235 (describing the events leading up to Pemex's creation); *cf.* Murphy, *supra* note 12, at 76 (providing the history of events leading to Mexico's current oil challenges).

41. *See* Kenneth S. Culotta, *Recipe for a Tex-Mex Pipeline Project: Considerations in Permitting a Cross-Border Gas Transportation Project*, 39 TEX. INT'L L.J. 287, 291 (2004)

In conjunction with Pemex's inception, the Mexican Congress adopted Article 27 of the Mexican Constitution, which declares Mexico's exclusive ownership of all subsoil resources.[42] In the late 1940s and early 1950s, Pemex granted exploration contracts that provided compensation based a percentage of production; however, this became illegal under the 1958 Regulatory Law of Constitutional Article 27 on Petroleum ("Petroleum Law of 1958").[43] Articles 25 and 28 of the Mexican Constitution underpin the Petroleum Law of 1958.[44] Article 25 provides that the public sector has exclusive control over strategic areas indicated in paragraph four of Article 28.[45] Article

(describing Pemex's monopoly position in the Mexican oil sector since 1938); *see also Energy and International Law: Development, Litigation, and Regulation, supra* note 10, at 58 (providing the history of Mexico's oil sector dating back to the 1920s).

42. *See* Constitución Política de los Estados Unidos Mexicanos [Const.], *as amended*, art. 27, para. 4, Diario Oficial de la Federación [D.O.], 5 de Febrero de 1917 (Mex.). The article states :

> The Nation has direct ownership of all natural resources of the continental shelf and the submarine shelf of the islands; all minerals or substances that are in veins, layers, or masses; beds of ore that constitute deposits naturally distinct form the components of the earth itself, such as the minerals from which industrial metals and metalloids are derived; deposits of precious stones; rock salt, and the salt deposits formed by sea water; products derived from the decomposition of rocks when subterranean works are required for their extraction; mineral or organic deposits of materials susceptible of utilization as fertilizers; solid mineral fuels; petroleum and all solid, liquid and gaseous hydrocarbons; and the space above the national territory, to the extent and within the terms established by international law.

Id., *translated in* [12 Const. of the Countries of the World] Mex. Const. 3/08, at 19-20 (Mar. 2008).

43. *See* Ley Reglamentaria del Artículo 27 Constitucional en el Ramo del Petróleo [Petroleum Law of 1958] *as amended*, art. 6 para. 1, D.O., 29 de Noviembre de 1958, (Mex.), *translated in* [2 Treaty Material] N. Am. Free Trade Agreements (Oxford Univ. Press) Booklet 21, at 2 (Apr. 2006) ("Petróleos Mexicanos may sign the contracts of works with a corporation or with a private person in order to better performance of its activities. The payment of those contracts will always be in cash and in no case shall percentages be based in the products, nor participation in the results of the exploitation be granted for the services that are lent or the works that are executed."); *see* Murphy, *supra* note 12, at 76 (providing a historical overview of Pemex's relationship with foreign companies).

44. *See* Petroleum Law of 1958, art. 2 (Mex.), *translated in* [2 Treaty Material] N. Am. Free Trade Agreements (Oxford Univ. Press) Booklet 21, at 2 (Apr. 2006) ("Only the State may carry out the different types of exploitation of hydrocarbon that constitute the oil industry within the terms of the following article.").

45. *See* Const (Mex.). art. 25, para. 4, *translated in* [12 Const. of the Countries of the World] Mex. Const. 3/08, at 17 (Mar. 2008) ("The public sector will have the exclusive responsibility over the strategic areas indicated in Article 28, paragraph four of the

28, paragraph four, refers to petroleum and other hydrocarbons, basic petrochemicals, and electricity as strategic areas within the exclusive functions of the state.[46] The Petroleum Law of 1958 gave a broad view of the petroleum sector to include the exploration, exploitation, refining, transportation, storage, distribution, and initial sale of petroleum.[47] This law further solidified Pemex's privileged position as the sole agent for the Mexican government's exploitation of Mexican oil.[48]

The most significant development since 1958 came in 1992 with the Pemex Organic Law, which restructured Pemex into four decentralized entities: (1) exploration and production; (2) refining; (3) gas and basic petrochemicals; and (4) secondary petrochemicals.[49] The fourth entity created by the Pemex

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Constitution. The Federal Government shall always maintain the ownership and control over any organization that are established for this purpose.").

46. *See id.* art. 28, para. 4, *translated in* [12 Const. of the Countries of the World] Mex. Const. 3/08, at 27 (Mar. 2008) ("The functions that the State exclusively exercises in the following strategic areas shall not constitute monopolies: postal delivery, telegraphs, and radio telegraphy; petroleum and other hydrocarbons; basic petrochemicals; radioactive minerals and the generation of nuclear energy; electric power and activities expressly provided by the laws enacted by the Congress of the Union.").

47. *See* Petroleum Law of 1958, art. 3, para. 2, *translated in* [2 Treaty Material] N. Am. Free Trade Agreements (Oxford Univ. Press) Booklet 21, at 1 (Apr. 2006) ("The oil industry embraces: The exploration, exploitation, manufacture and direct sale of gas as well as the transportation and the indispensable and necessary storage to interconnect its exploitation and manufacture.").

48. *See Energy and International Law: Development, Litigation, and Regulation*, *supra* note 10, at 58 (underscoring Pemex's historically privileged monopoly status in the oil sector); *see also* Culotta, *supra* note 41, at 288 (detailing Pemex's dominating political and economic presence since 1938).

49. *See* Ley Orgánica de Petróleos Mexicanos y Organismos Subsidiarios [Organic Act of Petróleos Mexicanos and its Subsidairy Bodies], *as amended*, art. 3, D.O., 16 de Julio de 1992 (Mex.). The law states:

> The following decentralized technical, industrial and commercial character, are created with legal status and their own assets, and will have the following objectives:
>
> I.PEMEX-Exploration and Production: exploration, exploitation; transportation, storage and commercialization of oil and natural gas;
>
> II.PEMEX-Refining: industrial refining process; manufacture of oil and oil derived products that serve as basic industrial raw materials; storage, transportation, distribution, commercialization of the mentioned products;
>
> III.PEMEX-Gas and Basic Petrochemicals: processing of natural gas, liquids natural and artificial gas; storage, transportation, distribution, commercialization of these hydrocarbons, as well as of derived products that serve as basic industrial raw materials; and

Organic Law was no longer considered a "strategic area" exclusive to the Mexican State in response to the needs of domestic and international markets.[50] The Foreign Investment Law of 1993 ("FIL") further relaxed the state's control over the petroleum sector by providing a framework for foreign investors to provide services related to transportation, distribution, and storage of natural gas through service contracts.[51] Foreign investors can now build, operate, and own pipelines, facilities and equipment; however, the FIL did not provide production and exploration risk-sharing activities in the oil sector to foreign investors.[52]

C. *Current Pemex Legislation Under the Calderón Administration*

In the spring of 2008, President Calderón introduced a bill that his party believes will revive Pemex.[53] President Calderón's proposal included incentive-based contracts for deepwater exploration, partnerships for deepwater drilling, and allowed private companies to retain ownership of refineries they build within Mexico's borders.[54] This proposal also sought to shake up Pemex's corporate structure to give it more autonomy from the

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> IV. PEMEX-Petrochemical: industrial petrochemical processes whose products are not part of the basic petrochemical industry, as well as their storage, distribution, and commercialization.

Id., *translated in* [2 Treaty Material] N. Am. Free Trade Agreements (Oxford Univ. Press) Booklet 20, at 1-2 (Apr. 2006).

50. *See id.*, art. 3, § IV.

51. Ley de Inversión Extranjera [Foreign Investment Law], as *amended*, art. 8, §§ X-XI, D.O., 27 de Diciembre de 1993 (Mex.). The law states:

> A favorable resolution by the Commission is required for foreign investment to participate in a percentage higher than 49% in the economic activities and corporations mentioned herein:
>
> X. Construction of pipelines for the transporting oil and its derivatives; and
>
> XI. Drilling of oil and gas wells.

Id., *translated in* 33 I.L.M. 212, 215 (1994).

52. *Id.*; *see* Homant, *supra* note 14, at 249 (describing that the Foreign Investment Law ("FIL") is generally vague, and only specific in permitting foreign companies to engage in distribution related activities in the hydrocarbon sector).

53. *See* Beaubien, *supra* note 6 (introducing President Calderón's initial Pemex reform proposal); *see also* Tobar, *supra* note 11 (addressing the main provisions set out in President Calderón's proposal).

54. *See* Beaubien, *supra* note 6 (discussing the provisions in Mr. Calderón's initial Pemex reform proposal); *see also Energy Reform in Mexico: Crude and Oily*, ECONOMIST, July 26, 2008, at 46 (reporting on the ensuing debate regarding President Calderón's initial energy reform proposal).

government.[55] However the proposal stopped short of allowing risk-sharing contracts with foreign companies or allowing a share in the discovery and production of oil.[56]

In late October of 2008, the Mexican Senate Energy Committee passed seven bills that allow Pemex to pay foreign companies to explore and produce oil based on performance.[57] These bills prevent Pemex from making profit-sharing agreements with foreign companies as well, to avoid a constitutional challenge in the courts under Articles 27 and 28.[58] Contrary to President Calderón's initial proposal, foreign companies are not allowed to build and own refineries.[59]

Critics claim these reforms fail to seriously address the concern over declining oil production.[60] However, government officials in Calderón's party who once viewed oil reform as a

55. *See* Ellingwood, *supra* note 1 (outlining President Calderón's more ambitious reform goals in his initial proposal); *see also Energy Reform in Mexico: Crude and Oily*, *supra* note 54 at 46 (highlighting President Calderón's major provisions in the proposal).

56. *See* Grillo, *supra* note 1 (noting the limitations on foreign activity that would remain under President Calderón's proposal); *see also* Gutierrez, *supra* note 6 (stating President Calderón's intentions for Pemex to remain solely owned by the Mexican government).

57. Ley Reglamentaria del Artículo 27 Constitucional en el Ramo del Petróleo [Petroleum Law of 1958], *as amended*, D.O., 28 de Noviembre de 2008 (Mex.); Ley de Petróleos Mexicanos [Pemex Law], D.O., 28 de Noviembre de 2008 (Mex.); Ley de Obras Públicas y Servicios Relacionados con las Mismas [Public Works and Related Services Law], *as amended*, D.O., 28 de Noviembre de 2008 (Mex.); Ley de Adquisiciones Arrendamientos y Servicios del Sector Público [Law of Public Acquisitions, Leases, and Services], *as amended*, D.O., 28 de Noviembre de 2008 (Mex.); Ley de la Comisión Reguladora de Energía [Energy Regulatory Commission Law], *as amended*, D.O., 28 de Noviembre de 2008 (Mex.); Ley de la Comisión Nacional de Hidrocarburos [National Hydrocarbons Commission Law], D.O., 28 de Noviembre de 2008 (Mex.); Ley para el Aprovechamiento Sustentable de la Energía [Law for Sustainable Energy Consumption], D.O., 28 de Noviembre de 2008 (Mex.); *see also* Ellingwood, *supra* note 1 (highlighting the main provision of the legislation); *see* Grillo, *supra* note 1, (providing the general purpose behind the Pemex reform legislation).

58. *See* Ellingwood, *supra* note 1 (demonstrating President Calderón's concern over the constitutionality of the Pemex reforms); *see also* Grillo, *supra* note 1 (stating some of the more ambitious goals for Pemex reform that the Mexican Constitution currently prohibits).

59. *See* Ellingwood, *supra* note 1 (explaining the compromise to redact incentive based contracts from his proposal to have the Pemex reforms passed by Congress); *see also* Grillo, *supra* note 1 (noting some of the limitations on foreign activity that remain after the October 2008 Pemex reform legislation).

60. *See* Ellingwood, *supra* note 1 (reporting an oil specialist's view that President Calerón's Pemex reforms did not sufficiently address Pemex's declining oil production); *see also* Grillo *supra* note 1 (referring to an oil analyst who believes the current oil reforms are inadequate and could lead to a further decline in oil production).

"political third rail" applaud the President's ability to reform Pemex at all.[61] They remain hopeful that these reforms forecast a shift in the public perception towards Mexico's oil, and are optimistic that these initial reforms will lead to more changes in the following years.[62]

II. *IMPLEMENTATION AND PROTECTION MODELS FOR FDI*

Part II of this Note outlines the potential reform models for President Calderón to attract FDI in Mexico's oil sector. One contemporary model, discussed in Part II.A, is the electric power sector reforms implemented in Mexico in 1992.[63] The Mexican government passed these reforms with moderate success, and the sector is gradually becoming more self-sufficient.[64] Part II.B will then examine the gradual opening of Brazil's petroleum sector, which encountered similar political obstacles that President Calderón currently faces, and may provide a second model for oil reform. Using Venezuela as a case study, Part II.C will consider the political risks for foreign investors, and the contractual mechanisms to mitigate these dangers. Finally, Part II.D discusses the Mexican government's cooperation under NAFTA, and NAFTA's ability to protect FDI from inequitable expropriation.

A. *Mexico's Electric Power Sector Model*

Over the last fifteen years, Mexico's electric power reform has eased the government's financial obligations in the previously nationalized sector.[65] The two prior Mexican presidents sought to further deregulate the electric power sector in gradual steps, while still keeping the sector under government regulation.[66] Former President Vicente Fox[67] presented the less

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61. *See* Ellingwood, *supra* note 1 (illustrating the political sensitivity over Pemex and Mexico's oil sector); *see also* Grillo, *supra* note 1 (suggesting that the October 2008 Pemex legislation may have created the opportunity for Mexican politicians to discuss Pemex reform more openly without suffering political backlash).

62. *See* Ellingwood, *supra* note 1 (noting the political importance of Pemex's nationalized status); *see also* Grillo, *supra* note 1 (suggesting that the October 2008 Pemex legislation may reflect a sea change in the Mexican people's perception over Mexico's oil).

63. *See infra* notes 65-75 and accompanying text.

64. *See infra* notes 76-77 and accompanying text.

65. *See infra* notes 65-75 and accompanying text.

66. *See infra* notes 78-89 and accompanying text.

ambitious reform proposal of the two, but the Mexican Supreme Court ultimately found the plan unconstitutional for violating Article 27.[68] The consequence of this ruling leaves many to wonder whether anything short of a constitutional amendment of Article 27 will provide the legal certainty that foreign companies desire before making long-term investments in Mexico's energy sector.[69]

The electric power reforms in 1992 allowed private investors to participate in two ways: through a build, lease, and transfer scheme ("BLT"); or as an independent power producer ("IPP").[70] Under the BLT model, a private investor finances the power plant's construction and leases it to the Federal Electricity Commission ("CFE") for twenty-five years.[71] Although the private party initially finances the plant in the construction phase, the CFE is responsible for the operation and maintenance of the plant for the duration of the lease.[72] At the conclusion of the lease, ownership passes to the CFE.[73] Under the IPP model, the power plant is owned and operated by the private party, but is required to sell the generated energy to the CFE for twenty-five years at a previously established rate through a public bidding process.[74] These models have helped reduce public spending in

67. President from 2000 to 2006. *See* Encyclopædia Britannica Online, Vicente Fox Quesada, http://www.britannica.com/EBchecked/topic/757093/Vicente-Fox (last visited Nov. 16, 2009).

68. *See infra* notes 89-92 and accompanying text.

69. *See infra* notes 93-95 and accompanying text.

70. *See* MIGUEL G. BRECEDA-LAPEYRE, PRIVATE INVESTMENT IN MEXICO'S ELECTRICITY SECTOR 4 (2002), *available at* http://www.cec.org/files/pdf/economy/mbinvest_en.pdf (introducing the build, lease, and transfer ("BLT") and independent power producer ("IPP") foreign investment models for Mexico's electric power sector); *see also Energy and International Law: Development, Litigation, and Regulation*, *supra* note 10, at 60 (outlining the two different investment models for Mexico's electric power sector).

71. *See* BRECEDA-LAPEYRE, *supra* note 70, at 4 tbl.1 (describing the BLT model); *see also Energy and International Law: Development, Litigation, and Regulation*, *supra* note 10, at 60 (describing the general BLT financial model).

72. *See* BRECEDA-LAPEYRE, *supra* note 70, at 4 tbl.1 (comparing the Federal Electricity Commission's ("CFE's") role in the BLT and the independent power producer model ("IPP")); *see also Energy and International Law: Development, Litigation, and Regulation*, *supra* note 10, at 60 (explaining the CFE's role under the BLT model).

73. *See* BRECEDA-LAPEYRE, *supra* note 70, at 4 tbl.1 (explaining the final step in the BLT investment model); *see also Energy and International Law: Development, Litigation, and Regulation*, *supra* note 10, at 60 (detailing the drawback to foreign investors under the BLT model).

74. *See* BRECEDA-LAPEYRE, *supra* note 70, at 4 tbl.1 (depicting the general IPP investment model); *see also* Rogelio Lopez Velarde, *A Step in the Right Direction?*

Mexico's electric power sector by allowing private parties to undertake a large portion of the financing, and the Mexican electric power sector is more self-sufficient as a result.[75]

A report prepared for the California Energy Commission applauded Mexico's IPP program for its ability to attract foreign investment while balancing the Mexican government's need to provide a regulatory scheme that protects its electric power sector.[76] The private sector's share in Mexico's electric power sector constitutes eighteen percent, and is projected to reach nearly fifty percent by 2010.[77] Given the political sensitivity of the oil sector, adopting a similar incremental approach to attract foreign investment may provide a stable privatization model for Pemex and ease the Mexican population's perceived threat to their national sovereignty if oil production increases.

While these public-private financing models provide a potential solution, it remains unclear just how far the Mexican government is willing to expand this privatization model in the electric power sector. To address this concern, former President Ernesto Zedillo[78] proposed an initiative to the Mexican Congress in February of 1999 to amend Articles 27 and 28 of the Constitution, and permanently remove the legal framework permitting the state's monopoly control over the electric power sector.[79] Under President Zedillo's plan, the CFE would have granted thirty-year concessions to private companies to operate power plants, but the government would still retain regulatory

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Privatization of Natural Gas Services in Mexico and an Examination of the Burgeoning Role of Local Distribution Companies, 8 U.S.-MEX. L.J. 37, 40 (2000) (providing an overview of Mexican natural gas reform, which led to increased private activity in the sector).

75. *See* BRECEDA-LAPEYRE, *supra* note 70, at 6 fig.2 (projecting the percentage of foreign activity in the Mexican electric power sector by 2010); *see also Energy and International Law: Development, Litigation, and Regulation*, *supra* note 10, at 60 (examining the effects of the BLT and the IPP models created after the 1992 power electricity reforms).

76. *See* POWER PROJECT FIN., MEXICO ENERGY PROJECT FINANCING 7-8 (2002), *available at* http://www.energy.ca.gov/2005publications/cec-600-2005-005/cec-600-2005-005.pdf (praising the ability of IPP program's ability to attract investors).

77. *See* BRECEDA-LAPEYRE, *supra* note 70, at 5 (estimating the percentage of private activity in the Mexican electric power by 2010).

78. President from 1994 to 2000. *See* WERNER, *supra* note 35, at 905.

79. *See* Emilio Carrillo Gamboa, *Proposed Changes for the Mexican Electric Industry*, 20 ENERGY L.J. 281, 281 (1999) (noting former President Zedillo's proposed changes to the electric power in 1999); *see also* Murphy, *supra* note 12, at 95 (describing the economic developments in the Mexican energy sector since the adoption of the North American Free Trade Agreement ("NAFTA")).

control over the basic power network for national security purposes.[80]

President Zedillo's proposal outlined a three-phase model for the transition.[81] During phase one, the CFE would remain state controlled, but break into three separate entities: generating, distribution, and transmission companies.[82] The government would also create a regulatory framework to facilitate a competitive wholesale electric power market as a precursor to a fully open market.[83] In phase two, both foreign and domestic private investors would be granted permission to generate and sell directly to qualified users.[84] The third and most controversial phase called for the eventual privatization of the CFE, but the government would still retain essential hydroelectric plants.[85] President Zedillo's ambitious proposal symbolized the broad vision of the Institutional Revolution Party ("PRI") during the 1990s to privatize Mexico's largest industries previously nationalized under their one-party rule.[86] However, President Zedillo was unable to forge the political will in Congress to approve the proposal, as his party lost a number of congressional seats from years of widespread corruption.[87] The proposal came

80. *See* Gamboa, *supra* note 79, at 283-84 (reviewing the three stages in President Zedillo's 1999 energy reform); Murphy, *supra* note 12, at 95 (outlining President Zedillio's 1999 energy reform proposal).

81. *See* Dement, *supra* note 34, at 44 (summarizing President Zedillo's three-phase electric power sector reform proposal); Gamboa, *supra* note 79, at 283 (outlining President Zedillo's three-step electric power sector reform proposal).

82. *See* Dement, *supra* note 34, at 44 (explaining the first phase of President Zedillo's proposal); *see also* Gamboa, *supra* note 79, at 283 (describing the first phase of President Zedillo's proposal).

83. *See* Dement, *supra* note 34, at 44 (describing the first phase of President Zedillo's proposal); *see also* Gamboa, *supra* note 79, at 284 (explaining the first phase of President Zedillo's proposal).

84. *See* Dement, *supra* note 34, at 45 (describing the second phase of President Zedillo's proposal); *see also* Gamboa, *supra* note 79, at 284 (explaining the second phase of President Zedillo's proposal).

85. *See* Dement, *supra* note 34, at 45 (describing the third phase of President Zedillo's proposal); *see also* Gamboa, *supra* note 79, at 284 (explaining the third phase of President Zedillo's proposal).

86. *See* Gamboa, *supra* note 79, at 281 (explaining that privatization initiatives would be easily passed under a PRI majority-controlled Congress); *see also* Murphy, *supra* note 12, at 77 (surveying the numerous privatization reforms in the 1990s under PRI administrations).

87. *See* Victor G. Carreón-Rodríguz et al., *The Mexican Electricity Sector: Economic, Legal and Political Issues*, *in* THE POLITICAL ECONOMY OF POWER SECTOR REFORM 198 n.10 (David Victor & Thomas C. Heller eds., 2007) (explaining the motivations and strategies

under intense scrutiny for attempting to remove the energy sector from the government's "strategic areas" under Article 28, as well as its encroachment on Congress' exclusive authority over the CFE's ability to purchase electricity absent a public bidding process.[88]

After winning the 2000 election, President Vicente Fox proposed creating an open electric power market for wholesale consumers to alleviative the strain on public finances.[89] This proposal did not deviate far from President Zedillo's original initiative, and the Mexican Supreme Court later invalidated it in an eight-to-three decision.[90] Five of the eleven Supreme Court justices found President Fox's proposed legislation contradicted the "public service of electricity" language in Article 27, paragraph 5, which prohibits any private generation of electricity for public consumption.[91] The three other justices struck down

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for reform in Mexico's electric power sector); *see also* Bourdeax, *supra* note 36 (reporting on the efforts to cleanse Mexican politics of corruption).

88. *See* Carreón-Rodríguz et al., *supra* note 87, at 200 (explaining Congress' concern that President Zedillo's reforms encroach on the traditional responsibilities of the legislative branch); *see also* Murphy, *supra* note 12, at 77 (describing the political fallout after President Zedillo's proposal was struck down as unconstitutional).

89. *See* BRECEDA-LAPEYRE, *supra* note 70, at 2-3 (stating President Fox's desire to establish a parallel electric power market to circumvent the public bidding process); Murphy, *supra* note 12, at 81 (distinguishing President Fox's energy proposal from President Zedillo's more ambitious plan for energy reform).

90. SERVICIO PÚBLICO DE ENERGÍA ELÉCTRICA. EL DECRETO QUE REFORMA Y ADICIONA LOS ARTÍCULOS 126, PÁRRAFOS SEGUNDO Y TERCERO, Y 135, FRACCIÓN II Y PÁRRAFOS ANTEPENÚLTIMO, PENÚLTIMO Y ÚLTIMO, DEL REGLAMENTO DE LA LEY RELATIVA, PUBLICADO EN EL DIARIO OFICIAL DE LA FEDERACIÓN EL VEINTICUATRO DE MAYO DE DOS MIL UNO, TRANSGREDE EL NUMERAL 89, FRACCIÓN I, DE LA CONSTITUCIÓN FEDERAL, AL DESVIRTUAR LA NATURALEZA JURÍDICA DE LAS FIGURAS DE AUTOABASTECIMIENTO Y DE COGENERACIÓN ESTABLECIDAS EN LA LEY QUE REGLAMENTA, PUES ALTERA EL CONCEPTO DE "EXCEDENTES", LO QUE IMPLICA, ADEMÁS, APARTARSE DE LOS PRINCIPIOS DE DIVERSO ARTÍCULO 27 DE LA NORMA FUNDAMENTAL, Pleno de la Suprema Corte de Justicia [S.C.J.N.] [Supreme Court], Semanario Judicial de la Federación y su Gaceta, Novena Epoca, tomo XV, Mayo de 2002, Página 607 (Mex.), *reprinted in* D.O., 3 de Junio de 2002, [hereinafter *Constitutional Controversy 22/2001*]; *see* Murphy, *supra* note 12, at 81 (comparing President Fox's energy proposal with President Zedillio's plan for energy reform).

91. *See id.*; *see also* Del Duca, *supra* note 36, at 131 n.536 (analyzing the Mexican Supreme Court majority's ruling that President Fox's energy proposal violated Article 27 of the Mexican Constitution). Article 27 states in relevant part:

> Furthermore, the Nation has the exclusive right to generate, conduct, transform, distribute, and supply electric power to be used for public service. No concessions for this purpose will be granted to private individuals, and the

the initiative based on a separation of powers argument, ruling that President Fox's reform exempted Congress' legislative intent to require a public bidding process to purchase electricity under Article 134 of the Constitution.[92] This line of reasoning suggests that the 1992 electricity reforms, based on a more flexible statutory reading of the "public service of electricity" language, would also violate the Constitution because they fail to provide a public bidding process under congressional authority.[93] The court's ruling jeopardizes any further expansion by private investors in the electric power sector, and questions the legality of prior investment contracts worth hundreds of millions of dollars.[94] This leaves many to speculate whether anything short of

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> nation will make use of the property and natural resources required to achieve these ends.

Const. art. 27 ¶ 6 (Mex.), *translated in* [12 Const. of the Countries of the World] Mex. Const. 3/08, at 21 (Mar. 2008).

92. *See Constitutional Controversy 22/2001*, *supra* note 90; *see also* Del Duca, *supra* note 36, at 131 n.536 (analyzing the concurring conclusion that President Fox's energy proposal encroached on the Mexican congress's authority to require a public bidding process to govern foreign activity in the electric power sector). Article 134 of the Mexican Constitution provides as follows:

> The economic resources available to the Federal Government and the Government of the Federal District as well as to their respective state administrations will be administered with efficiency, effectiveness, and honor, to satisfy the objectives to which they are destined.
>
> All acquisitions, leases, and transfers of all classes of goods, provisions of services of any nature, and the contracting of works that the government undertakes shall be awarded or carried out through open bidding by means of a public call so that solvent proposals may be freely submitted. The proposals shall be presented as sealed bids, to be open publicly, so as to ensure to the state the best conditions possible with regards to price, quality, financing, opportunity, and other pertinent circumstances.

Const. art. 134 (Mex.), *translated in* [12 Const. of the Countries of the World] Mex. Const. 3/08, at 113 (Mar. 2008).

93. *See* Del Duca, *supra* note 36, at 131 (examining the consequences of the Mexican Supreme Court's analysis concerning private activity in Mexico's electric power sector); *see also* Elisabeth Malkin, *Mexico Turns to Investors to Add to Power Capacity*, N.Y. TIMES, Mar. 18, 2003, at W1 (reporting on the impact of the court decision negating President Fox's energy reform for foreign investors).

94. *See* Richard Lapper, *Pemex: Change Is Needed, But Far from Easy*, FIN. TIMES (London), Dec. 12, 2005, at 3 (discussing the difficulties to energy reform after the Mexican supreme court invalidated President Fox's energy proposal); *see also* Malkin, *supra* note 93 (reporting that the Mexican supreme court's ruling questions the constitutionality of the 1992 electric power reforms).

a constitutional amendment restricting the scope of Articles 27 and 28 will achieve substantive reform in the energy sector.[95]

Constitutional amendments require a two-thirds vote in Congress, accompanied by the approval of a majority of the thirty-one state legislatures.[96] Until President Fox's presidential victory in 2000, the PRI's dominant presence in both the federal and state governments reduced the amendment process to a mere formality.[97] While several moderates within the PRD have joined the PAN to reform the oil sector, their left-wing coalition is unwavering, and has additional support from the labor unions and the PRI orthodoxy.[98] Mr. Obrador continues to oppose any dilution of Pemex's monopoly, and the Pemex workers union will fight any reform threatening to reduce their role in the oil sector.[99] Despite these challenges, President Calderón has made some progress by creating a dialogue over Pemex's future. Just as the political battles in Brazil ultimately led to foreign participation in their once nationalized oil sector,[100] incremental progress in Mexico may eventually provide enough financial incentive for foreign companies to participate more substantially with Pemex.

B. *Petrobras as a Model for Reform*

In the mid-1990s Brazil successfully opened its oil sector to private companies through incremental reform and regulation,

95. *See* Lapper, *supra* note 94, at 3 (interviewing an oil expert at the National Autonomous University of Mexico on his assessment on the prospects of energy sector reform); *see also* Del Duca, *supra* note 36, at 133 (examining President Fox's decision to include constitutional changes to Articles 27 and 28 in his next reform proposal).

96. *See* Del Duca, *supra* note 36, at 106 (explaining the legal hurdles required to achieve substantive energy reform); *see also* Murphy, *supra* note 12, at 96 (explaining the constitutional amendment process).

97. *See* Del Duca, *supra* note 36, at 106 (explaining why it is now more difficult to pass a constitutional amendment); *see also* Murphy, *supra* note 12, at 81 (describing the changing political landscape in Mexico and its effect on the political process).

98. *See* Black & Martinez, *supra* note 11 (explaining the division in the PRI over oil reform); *see also* Grillo, supra note 1 (reporting about the political parties who stand for and against the Pemex reforms).

99. *See* Black & Martinez, *supra* note 11 (illustrating the Pemex workers union's political influence); *see also* Lapper, *supra* note 94, at 3 (describing the political clout of Pemex's workers union and the political left in Mexico).

100. *See infra* notes 106-109 and accompanying text.

despite public concern over losing control of this vital sector.[101] The effect of these reforms ultimately kept the state-owned oil company, Petróleo Brasileiro ("Petrobras"), afloat during Brazil's economic woes in the 1990s, and sustained Petrobras' viability in the twenty-first century.[102] The Brazilian government was able to address its need to attract foreign capital while still maintaining significant control over the oil sector.[103] The Brazilian government's handling of Petrobras within a political environment analogous to Mexico may provide the Mexican government a relevant model for oil reform.[104] In fact, Petrobras recently expanded an already existing technology sharing agreement with Pemex and has even given tours of its facilities to Mexican lawmakers to show how the company has transformed since allowing private investments in the Brazilian oil sector.[105]

In 1995 Brazil successfully passed constitutional reforms necessary to attract foreign investment in its oil sector by allowing the government to make concessions to private oil companies.[106]

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101. *See* Marilda Rosado de Sa Ribeiro, *The New Oil and Gas Industry in Brazil: An Overview of the Main Legal Aspects*, 36 Tex. Int'l L.J. 141, 142-43 (2001) (illustrating the political-economic environment during the implementation of privatized oil reform); *see also Energy and International Law: Development, Litigation, and Regulation*, *supra* note 10, at 63 (depicting challenges of privatizing a nationalized oil sector).

102. *See* Miller, *supra* note 18, at 838-39 (reporting on Petróleo Brasileiro's ("Petrobras") production increases since 2003); *see also* Rosado de Sa Ribeiro, *supra* note 101, at 142 (noting Brazil's economic challenges in the 1990s).

103. *See* John E. Rhea, *Privatization in the International Petroleum Industry: The Interplay Between Politics, Economics, and Reliance*, 33 DENV. J. INT'L L. & POL'Y 609, 631-32 (2005) (providing some of the advantages to state-controlled industries); *see also* Miller, *supra* note 18, at 843-44 (noting that Petrobras maintained control over some of the wells given to private parties after the development stage).

104. See James Brooke, *Brazil Takes Big Step Toward Ending State Monopoly over Oil*, N.Y TIMES, June 8, 1995, at A21 (describing the hostile political climate as Brazil's Congress passed the constitutional amendment allowing foreign companies to participate in Brazil's oil sector); *see also* Rhea, *supra* note 103, at 631-32 (comparing the state-owned oil sectors of Brazil, Mexico, Nigeria, and Venezuela).

105. *See* Malkin, *supra* note 19 (explaining that several foreign companies currently have agreements with Pemex); *see also* Black & Martinez, *supra* note 11 (demonstrating Petrobras' interest in seeing Pemex take similar steps to increase foreign participation in Mexico's oil sector).

106. Constituição Federal [C.F.], *as amended*, art. 177 (Brazil). Specifically, article 177 of the Constitution reads:

The Union has a monopoly on the following areas:

I. prospecting and exploitation of deposits of petroleum, natural gas and other fluid hydrocarbons;

II. refining domestic or foreign petroleum ;

The amendment led to Petroleum Law 9478, allowing private oil companies to bid for exploration and production rights in territorial blocks offered by the government.[107] This law also created the National Petroleum Agency ("ANP") to regulate these private companies' activities.[108] The law permitted the

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III. importation or exportation of products and basic by-products resulting from the activities set forth in the prior sub paragraphs;
IV. maritime transportation of crude oil of domestic origin or of basic petroleum by-products produced in the Country, as well as the pipeline transportation of crude oil, its by-products and natural gas of whatever origin;
V. prospecting, mining enrichment, reprocessing, industrialization or commerce in ores and nuclear minerals and their by-products, with the exception of radioisotopes whose production, marketing and utilization may be authorized under a permit regime, in accordance with subparts b and c of subparagraph XXIII of the heading of art. 21 of this Federal Constitution.

1. The Union may contract with state or private firms to perform the activities provided for in subparagraph I to IV of this article, observing the conditions established by law.
2. The law referred to in the first section shall provide for:
   I.guarantee of furnishing petroleum by-products in the entire national territory;
   II.the conditions of contracting;
   III.the structure and power of the agency regulating the Union's monopoly;
3. The law shall provide for the transportation and use of radioactive materials within the national territory.

C.F. art. 177 (Brazil), *translated in* [3 Const. of the Countries of the World] Brazil Const. 9/08, at 140-41 (May 2008).

107. Decreto No. 9.478, de 6 de agosto de 1997, arts. 8(IV), 72, D.O.U., de 07.08.1997 (Brazil). Article 8(IV) states:

> The purpose of the National Petroleum Agency ("ANP") will be to promote regulatoion, contracting and supervision of the economic activities of the petroleum industry, being responsible for: drafting invitations to bid and conducting bidding process for exploration, development, and production concessions; executing the respective contracts and supervising its performance;

Id. art. 8(IV) *translated in* [2 Doing Business in Brazil] Law No. 9478 of Aug. 6, 1997 (Juris Publishing, Inc.) App. 2S, at 4 (Aug. 1997). Article 72 provides:

> For a period of 5 years, from the date of enactment of the present law, the Union shall assure, through the ANP, to the private refineries operating in the country, as excluded from the Union monopoly according to Article 45 of the Interim Constitutional Disposition, operational and economic conditions based on prevailing criteria for payment of refining activity.

Id., *translated in* [2 Doing Business in Brazil] Law No. 9478 of Aug. 6, 1997 (Juris Publishing, Inc.) App. 2S, at 18 (Aug. 1997); *see also* Rosado de Sa Ribeiro *supra* note 101, at 147 (explaining the Brazil's gradual four year legislative struggle to attract foreign oil companies to participate with Petrobras).

108. *See* Decreto No. 9478, art. 7 & 72(II)-(III). Article 7 states:

Brazilian government to break up the state-controlled oil company Petrobras into individual business units, and set profit targets for government appointed executives in each department.[109]

By 1999 the Brazilian government awarded twelve territorial blocks to fourteen companies representing six countries.[110] Within one year, that number nearly doubled to twenty-one blocks coming from eight new operators.[111] To further encourage foreign investment, Brazil allows foreign oil and gas companies to keep their accounts in foreign currencies.[112] Reforming Petrobras allowed the government to place twenty-eight percent of voting stock in the company on local and

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> The ANP, an integral entity of the indirect Federal Administration, subject to special agency regime, as a regulatory body for the petroleum industry, affiliated to the Ministry of Mines and Energy, is hereby created.

Id. art. 7, *translated in* [2 Doing Business in Brazil] Law No. 9478 of Aug. 6, 1997 (Juris Publishing, Inc.) App. 2S, at 4 (Aug. 1997). Article 72 provides in pertinent part:

> II. Private refineries are obliged to submit to the ANP an investment plan aimed at technological update and expansion of their refining capacity, in view of their increase of production and consequent reduction of subsidies;
>
> III. The ANP shall periodically evaluate the level of competitiveness of each private refinery and the achievement of their investment plan and the consequent reduction of related subsidies.

Id. art. 72(II)-(III), *translated in* [2 Doing Business in Brazil] Law No. 9478 of Aug. 6, 1997 (Juris Publishing, Inc.) App. 2S, at 18 (Aug. 1997).

109. *See id.*, arts. 63-64, *translated in* [2 Doing Business in Brazil] Law No. 9478 of Aug. 6, 1997 (Juris Publishing, Inc.) App. 2S, at 17 (Aug. 1997) (Art. 63: "Petrobrás and its subsidiaries are hereby authorized to establish consortiums with national or foreign companies, whether as the leader company or not, with the purpose of expanding activities, increasing its technologies and enlarging investments in the petroleum industry"; Art. 64: "For the strict compliance of the its corporate objectives, which are integral to the petroleum industry, Petrobrás is authorized to establish subsidiaries which may associate, either on a majority or minority basis, with other companies."); *see also* John Barham, *Petrobras's Makeover Man*, LATINFINANCE, Sept. 2000, at 2 (highlighting the Petrobras CEO's modern business approach towards the company).

110. *See* Rosado de Sa Ribeiro, *supra* note 101, at 163 (describing the extent of foreign activity in Brazil's oil sector in 1999); *see also Energy and International Law: Development, Litigation, and Regulation*, *supra* note 10, at 63 (examining the effects four years after the Petrobras reform).

111. *See* Rosado de Sa Ribeiro, *supra* note 101, at 163 (describing the extent of foreign activity in Brazil's by year-end 1999); *see also Energy and International Law: Development, Litigation, and Regulation*, *supra* note 10, at 63 (examining the effects four years after the Petrobras reform).

112. *See* Rosado de Sa Ribeiro, *supra* note 101, at 164 (describing legislation to further induce foreign companies to invest in Brazil's oil sector); *see also Energy and International Law: Development, Litigation, and Regulation*, *supra* note 10, at 63 (highlighting an example by the Brazilian government to further attract FDI).

international markets, and Petrobras is now listed on the New York Stock Exchange.[113] The legislation successfully helped Brazil become more self-sufficient in its oil production, and Petrobras continues to make headlines with its large oil discoveries.[114]

C. *FDI Expropriation Risk Illustrated in Venezuela*

While constitutional reform is a crucial first step to attract foreign investors, protecting their investments abroad is perhaps the most important concern. Foreign companies looking to invest in another country's oil sector typically negotiate long-term contracts, and provide a large proportion of the business investment upfront.[115] These high sunk costs can be particularly vulnerable to expropriation once a large proportion of the private investor's assets are within the borders of a foreign government.[116] Venezuelan President Hugo Chavez's heavily publicized national goal for "Full Energy Sovereignty" illustrates this inherent risk with FDI in the oil sector.[117] While President Chavez's national plan poses a dangerous scenario for foreign companies, a number of them had previously negotiated contractual provisions to mitigate the economic risk in the event of expropriation by the Venezuelan government.[118]

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113. *See* Barham, *supra* note 109, at 2 (illustrating the scope of Petrobras' capitalization efforts); *see also* Rosado de Sa Ribeiro, *supra* note 101, at 150 (describing the public and private characteristics to the Petrobras company).

114. *See* Barham, *supra* note 109, at 2 (noting the CEO of Petrobras' assessment that Petrobras could become self-sufficient by 2005); *see also* Miller, *supra* note 18, at 843 (providing examples of long-term investments that will achieve Brazil's goal of self-sufficiency in its oil sector).

115. *See* Brandon Marsh, *Preventing the Inevitable: The Benefits of Contractual Risk Engineering in Light of Venezuela's Recent Oil Field Nationalization,* 13 STAN. J.L. BUS. & FIN. 453, 454 (2008) (explaining that energy production contracts typically require long-term investments); *see also* B. Seth McNew, *"Full Sovereignty Over Oil": A Discussion of Venezuelan Oil Policy and Possible Consequences of Recent Changes,* 14 LAW & BUS. REV. AM. 149, 155 (2008) (examining the effects of increased government regulation by the Venezuelan government on foreign oil companies with large investments).

116. *See infra* notes 119-120, and accompanying text.

117. *See* Marsh, *supra* note 115, at 454 (detailing the financial structure of the contracts that foreign companies negotiated prior to the threat of expropriation by the Venezuelan government); *see also* McNew, *supra* note 115, at 153-54 (examining Venezuela's recent measures to further increase government control in the oil sector).

118. *See* Marsh, *supra* note 115, at 463-65 (detailing the contractual provisions designed to protect FDI in Venezuela's oil sector); *see also* Erik J. Woodhouse, *The Obsolescing Bargain Redux? Foreign Investment in the Electric Power Sector in Developing*

Long-term contracts that require a large initial investment provide a number of challenges for contract drafters negotiating foreign oil projects because there is a heightened risk of expropriation by the host government.[119] Once an investor has made a proportionally large investment into the host country's infrastructure, the host country obtains increased financial leverage to renegotiate for more beneficial terms, or to simply breach the entire contract.[120] This is known as an "obsolescing bargain" because the host government's increased bargaining power makes the previously negotiated contract terms essentially "obsolete."[121] In the 1990s, the Venezuelan government was negotiating thirty-year concession contracts with foreign oil companies to develop and produce Venezuela's oil.[122] By 2000, newly elected Democratic-Socialist President Hugo Chavez renegotiated the terms of those contracts to obtain a majority stake in the oil sector by threatening to expropriate the industry.[123] These "renegotiated" terms raised taxes and royalties, and increased the market share of Venezuela's state-owned oil company, Petróleos de Venezuela, in their country's oil sector.[124]

Foreign companies must anticipate these situations to insulate themselves from further risk. For example, foreign

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Countries, 38 N.Y.U. J. INT'L. L. & POL. 121, 127-28 (2006) (examining various IPP models from developing countries to best reduce the risk of expropriation).

119. *See* Marsh, *supra* note 115, at 457 (explaining the increased risk of expropriation in high sunk cost investment models); *see also* Woodhouse, *supra* note 118, at 127 (observing that foreign investments in infrastructure projects pose heightened risk of expropriations).

120. *See* Marsh, *supra* note 115, at 457 (stating how host countries are placed in an advantageous position after high-sunk-cost investments are made); *see also* Woodhouse, *supra* note 118, at 127 (describing a host country's increased financial leverage during the early stages of a high sunk investment project).

121. *See* Marsh, *supra* note 115, at 457 (defining the obsolescing bargain theory); *see also* Woodhouse, *supra* note 118, at 127 (explaining concept of obsolescing bargain).

122. *See* Marsh, *supra* note 115, at 454 (describing the Venezuelan government's negotiations with foreign investors prior to the election of President Chavez); *see also* McNew, *supra* note 115, at 151-52 (explaining that prior FDI agreements led to foreign companies gaining a majority share in some of Venezuela's most lucrative oil reserves).

123. *See* Marsh, *supra* note 115, at 454 (summarizing the contract terms renegotiated in the Venezuelan government's favor); *see also* McNew, *supra* note 115, at 153-54 (addressing President Chavez's plan to regain majority control over Venezuela's most profitable oil reserves).

124. *See* Marsh, *supra* note 115, at 453-54 (describing the actions taken by the Venezuelan government after President Chavez took office); *see also* McNew, *supra* note 115, at 149-50 (describing the consequences of President Chavez's oil nationalization plan).

companies investing in Venezuela's oil sector contracted maximum price levels to discourage the Venezuelan government from expropriating if oils prices rose too high.[125] These companies also typically negotiate a baseline price to prevent governmental interference if pressured to increase their short-term revenues when oil prices drop.[126] In conjunction with setting price levels, companies can use a host country's foreign assets as collateral in the event that the host government seeks to expropriate.[127] This gives debt-holders access to oil exports to recoup their loans, and provides security in financing large projects in foreign countries.[128] Lastly, foreign companies can make explicit provisions for offshore international arbitration to settle their dispute in a neutral setting, and enforce an award using the host country's foreign assets and export revenues.[129]

D. *FDI Protection Under NAFTA*

Expropriating foreign enterprises without adequate compensation is the biggest risk to foreign investors, and a serious impediment to foreign investment in developing countries.[130] The United States and other industrialized countries responded to this fear by establishing bilateral and multilateral

125. *See* Marsh, *supra* note 115, at 465-66 (explaining how price control provisions discourage expropriation); *see also* Woodhouse, *supra* note 118, at 171-72 (discussing the common contractual provisions in an IPP investment agreement).

126. *See* Marsh, *supra* note 115, at 466 (describing how price control provisions are designed to discourage expropriation); *see also* Woodhouse, *supra* note 118, at 171-72 (illustrating the common contractual provisions in an IPP investment agreement).

127. *See* Marsh, *supra* note 115, at 466 (demonstrating how foreign investors are compensated if their investment is expropriated); *see also* Woodhouse, *supra* note 118, at 175 (illustrating how an expropriating government may find it difficult to escape payment of award ruled against them).

128. *See* Marsh, *supra* note 115, at 466-67 (explaining how foreign assets of a host country can be used as collateral to persuade creditors to finance large international investment projects); *see also* Woodhouse, *supra* note 118, at 175 (listing types of secure payment provision that may be used in an international investment contract).

129. *See* Marsh, *supra* note 115, at 467 (explaining how international arbitration allows foreign investors to bring their claims in a neutral environment and recover an award from an expropriating country); *see also* Woodhouse, *supra* note 118, at 181 (noting that private investors are gravitating towards offshore international arbitration to settle dispute with foreign governments).

130. *See* Homant, *supra* note 14, at 251 (addressing how concerns over expropriation led to international investment treaties; *see also* Sandrino, *supra* note 38, at 315-16 (addressing the United States' concern over protecting foreign investments).

investment treaties to protect their foreign investments.[131] These international treaties provide an enhanced degree of certainty on the rules governing foreign investment, and empower foreign investors to enforce their contractual rights against a host country through international arbitration proceedings.[132] NAFTA is a multilateral treaty between Mexico, the United States, and Canada designed to encourage free trade, promote fair competition, and increase foreign investment in the region.[133] Given Mexico's historically hostile position towards FDI,[134] their ratification of NAFTA is an important first step to minimize a foreign investor's fear of expropriation without adequate compensation.

Chapter 11 of NAFTA sets the legal standards for the treatment of foreign investors from other NAFTA countries, and allows investors to settle disputes with a host country in international arbitration.[135] In accordance with traditional principles of international law, chapter 11 declares that host countries may not expropriate investments unless for a public purpose, on a nondiscriminatory basis, under due process of law,

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131. *See* Robbins, *supra* note 23, at 404 (explaining how international investment treaties encourage foreign investment into developing countries); Sandrino, *supra* note 38, at 316 (providing the policy rational behind international investment treaties).

132. *See* Robbins, *supra* note 23, at 404, 414 (discussing the reasons why countries create investment treaties); *see also* Raul Emilio Vinuesa, *Bilateral Investment Treaties and the Settlement of Investment Disputes Under ICSID: The Latin American Experience*, 8 LAW & BUS. REV. AM. 501, 504-05 (2002) (explaining why international investment treaties have proliferated in recent years).

133. North American Free Trade Agreement art. 102(1)(a)-(c), U.S.-Can.-Mex., Dec. 17, 1992, 32 I.L.M. 289 (1993) [hereinafter NAFTA]. Article 102 states:

> Objectives:
>
> 1. The objectives of this Agreement, as elaborated more specifically through its principles and rules, including national treatment, most-favored-nation treatment and transparency, are to:
>
> a) eliminate barriers to trade in, and facilitate the cross-border movement of, goods and services between the territories of the Parties;
>
> b) promote conditions of fair competition in the free trade area;
>
> c) increase substantially investment opportunities in the territories of the Parties . . .

Id.

134. *See infra* notes 145-48 and accompanying text.

135. *See* Del Duca, *supra* note 36, at 86-87 (explaining the purpose of NAFTA chapter 11); *see also* Gregory M. Starner, *Taking a Constitutional Look: Chapter 11 as an Extension of Member States' Constitutional Protection of Property*, 33 LAW POL'Y INT'L BUS. 405, 418-19 (2002) (introducing the dispute resolution protections of NAFTA under chapter 11).

and with fair compensation.[136] The principle characteristic of customary international law is the actual conduct of nation-states in their international relations.[137] This conduct is often found in official diplomatic communications, which nations implicitly consent to through practice.[138] Western laissez-faire ideas and liberal concepts of property developing towards the end of the nineteenth century prompted industrializing nations to establish international standards to protect the investments of their nationals abroad.[139] As a result, customary international law of expropriation developed in favor of protecting the private property of aliens and to restrict a host state interference with private property.[140]

Several Latin American countries consider the traditional rules of customary international law to be a vestige of imperialism, and oppose them on the belief that they would impede their ability to carry out necessary reforms during an economic crisis.[141] Alternatively, these countries adhere to the Calvo Doctrine, which allows their domestic courts to determine

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136. NAFTA, *supra* note 133, art. 1110(1). Article 1110(1) states:

No Party may directly or indirectly nationalize or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment ("expropriation"), except:

(a) for a public purpose;

(b) on a non-discriminatory basis;

(c) in accordance with due process of law and Article 1105(1); and (d) on payment of compensation in accordance with paragraphs 2 through 6").

137. *See* SHABTAI ROSENNE, PRACTICE AND METHODS OF INTERNATIONAL LAW 55-56 (1984) (discussing the development of customary international law); *see also* VAGTS, DETLEV, WILLIAM S. DODGE & HAROLD HONGJU KOH, TRANSNATIONAL BUSINESS PROBLEMS 62-63 (4th ed. 2008) (providing examples of customary international law).

138. *See* SHABTAI ROSENNE, PRACTICE AND METHODS OF INTERNATIONAL LAW 55-56 (1984); *see also* VAGTS, DETLEV, WILLIAM S. DODGE & HAROLD HONGJU KOH, TRANSNATIONAL BUSINESS PROBLEMS 62-63 (4th ed. 2008).

139. *See* Sandrino, *supra* note 38, at 265-66 (explaining how the global political-economic framework has molded expropriation standards over time); *see also* Samuel K.B. Asante, *International Law and Foreign Investment: A Reappraisal*, 37 INT'L & COMP. L.Q. 588, 590 (1988) (describing how customary international expropriation standards developed from the law of State responsibility for injury to aliens and their alien property).

140. *See* Sandrino, *supra* note 38, at 265-66; *see also* Samuel K.B. Asante, *International Law and Foreign Investment: A Reappraisal*, 37 INT'L & COMP. L.Q. 588, 590 (1988).

141. *See* Robbins, *supra* note 23, at 410-11 (perceiving the political opposition to customary international standards of law); *see also* Sandrino, *supra* note 38, at 319 (explaining why Latin American countries oppose customary international law standards).

the value of compensation.[142] Domestic courts typically protect foreign investments only to the extent that they protect their own citizenry, which often falls below the standards set by customary international law.[143]

Article 1110 in chapter 11 of NAFTA explicitly provides for adequate compensation, without delay, equal to the fair market value, with interest, at the time of the expropriation.[144] This represents an important change from Mexico's longstanding policy of expropriating foreign property under the Calvo Doctrine, which is implicitly referenced in Mexico's constitution.[145] NAFTA's dispute resolution mechanism also

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142. *See* Sandrino, *supra* note 38, at 319 (laying out the rationale for adopting the Calvo Clause); *see also* Starner, *supra* note 135, at 432 (explaining that Mexico recognizes solving disputes with NAFTA member states through international arbitration under chapter 11).

143. *See* Robbins, *supra* note 23, at 410 (explaining the difference between customary standards of international law and the Calvo Clause); *see also* Sandrino, *supra* note 38, at 319 (comparing the provisions in Article 27 of the Mexican Constitution with NAFTA, chapter 11).

144. NAFTA, *supra* note 133, art. 1110(1)-(4). Article 1110 states in specific:

> 1. No Party may directly or indirectly nationalize or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment ("expropriation"), except:
>
> (a) for a public purpose;
>
> (b) on a non-discriminatory basis;
>
> (c) in accordance with due process of law and Article 1105(1); and
>
> (d) on payment of compensation in accordance with paragraphs 2 through 6").
>
> 2. Compensation shall be equivalent to the fair market value of the expropriated investment immediately before the expropriation took place ("date of expropriation"), and shall not reflect any change in value occurring because the intended expropriation had become known earlier. Valuation criteria shall include going concern value, asset value including declared tax value of tangible property, and other criteria, as appropriate, to determine fair market value.
>
> 3. Compensation shall be paid without delay and be fully realizable.
>
> 4. If payment is made in a G7 currency, compensation shall include interest at a commercially reasonable rate for that currency from the date of expropriation until the date of actual payment.

Id. art. 1110.

145. Article 27 of the Mexican Constitution reads that "the Nation shall carry out the exploitation of these product, consistent with the provisions established in the respective regulatory law." Const. art. 27 para. 6 (Mex.), *translated in* [12 Const. of the Countries of the World] Mex. Const. 3/08, at 21 (Mar. 2008); *see also* Starner, *supra* note 135, at 415 (examining the tension between chapter 11 of NAFTA and Mexico's constitutional framework).

demonstrates Mexico's divergence from the Calvo Doctrine.[146] Mexico historically required foreign investors to pursue their legal claims arising in Mexico under Mexican law.[147] This allowed Mexico to establish the "fair value" for expropriation based on its domestic standards, often resulting in less than the fair market value standard set by customary international law.[148]

Under article 1116 of NAFTA, foreign investors may submit a claim for arbitration, using applicable rules of international law, for loss or damage resulting from a breach by the host country.[149] The most noteworthy arbitration cases filed under NAFTA analyze the extent to which a host government's activities constitute an expropriation requiring adequate compensation.[150] *Pope & Talbot*, for example, established a "regulatory taking" as regulations amounting to interference "sufficiently restrictive" that the property has been taken from the owner.[151] *Metalclad Corp.* expanded the scope of expropriation to cover indirect and "creeping expropriation."[152] The *Metalclad* tribunal concluded that the Mexican government's regulations essentially restricted the claimant's use and "reasonably-to-be-expected" economic

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146. *See* Sandrino, *supra* note 38, at 322 (suggesting that Mexico's distrust for private arbitration is diminishing)*; see also* Homant, *supra* note 14, at 251 (explaining how Mexico's indoctrination of the Calvo Clause differs from its recent acquiescence to internationally recognized FDI protection standards).

147. *See* Homant, *supra* note 14, at 251 (citing Mexico's traditional practice of not recognizing international arbitration as an adequate mechanism to settle disputes arising in Mexico); *see also* Starner, *supra* note 135, at 415 (summarizing Mexico's investment policies under the Calvo Doctrine).

148. *See e.g.*, Metalclad Corp. v. United Mexican States, Final Award, 40 I.L.M. 36, ¶ 116 (NAFTA Arb. Trib. 2000) (alleging that Metalclad's award should be limited to the cost of state's capitalization efforts in the waste management industry); *see also* Del Duca, *supra* note 36, at 138 (explaining how NAFTA's arbitration provisions protect foreign investors from discrimination in Mexico's domestic courts).

149. *See* NAFTA, *supra* note 133, art. 1116(1) ("An investor of a Party may submit to arbitration under this Section a claim that another Party has breached an obligation . . . .").

150. *See generally* Céline Lévesque, *Distinguishing Expropriation and Regulation Under NAFTA Chapter 11: Making Explicit the Link to Property*, *in* THE FIRST DECADE OF NAFTA: THE FUTURE OF FREE TRADE IN NORTH AMERICA 293 (Kevin C. Kennedy ed., 2004) (exploring nature of expropriation in NAFTA arbitration); Jessica C. Lawrence, *Chicken Little Revisited: Regulatory NAFTA Expropriation After Methanex*, 41 GA. L. REV. 261 (2006) (same).

151. Pope & Talbot, Inc. v. Canada, Interim Award, 7 ICSID Rep. 69, ¶ 102 (NAFTA Arb. Trib. 2000).

152. *See Metalclad*, Final Award, ¶¶ 102-03.

benefit of the property.[153] In *S.D. Myers*, however, the arbitral tribunal refined the scope of expropriations to involve only the "deprivation of ownership rights," whereas "mere regulations" represented a lesser interference insufficient to constitute a taking for adequate compensation.[154]

This line of cases demonstrates the gradual development of expropriation standards, allowing foreign investors to enter into host-countries with a greater understanding of the scope of protection under NAFTA. More importantly, the *Metalclad* case illustrates Mexico's acquiescence to independent arbitration for expropriation disputes.[155] The arbitration process in *Metalclad* prevented the Mexican government's constitutional defense, under Article 27, that fair value compensation should be limited to the value Metalclad previously accepted under the Mexican tax code for tax benefits.[156] Metalclad's decision to settle its dispute under NAFTA chapter 11 arbitration demonstrates that international arbitration affords a better opportunity for independent recognition of an investor's claims than a host country's judicial system.[157] Although this limits the Mexican government's ability to settle disputes occurring in its country though its own judicial system, this may ultimately encourage foreign companies to increase foreign investments in Mexico.

While NAFTA provides uniformity and increased certainty over expropriation standards that protect FDI, each country has reserved exceptions for sensitive industries where private investment is not permitted.[158] Not surprisingly, Mexico

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153. *Id.* ¶¶ 103, 106-07.

154. *See* S.D. Myers, Inc. v. Canada, Partial Award, 40 I.L.M. 1408, ¶¶ 282-83 (NAFTA Arb. Trib. 2000).

155. *See* Del Duca, *supra* note 36, at 121 (discussing the implications of *Metalclad*); *see also* Starner, *supra* note 135, at 423-24 (noting Mexico's deference to the tribunal's ruling in *Metalclad*).

156. *See* Del Duca, *supra* note 36, at 138 (explaining how NAFTA's arbitration mechanism protected Metalclad from any potential discrimination in Mexico's domestic courts); *see also* Starner, *supra* note 135, at 432 (observing that NAFTA arbitral tribunals apply the NAFTA provisions and international law in lieu of Mexican Law).

157. *See* Del Duca, *supra* note 36, at 137 (examining the benefits provided by chapter 11 arbitration under NAFTA); *see also* Starner, *supra* note 135, at 419 (listing the advantages NAFTA arbitration provides to foreign companies over the Mexican legal system).

158. *See* NAFTA, *supra* note 133, annexes 602.3, 603.6; Homant, *supra* note 14, at 250 (discussing Mexico's list of exceptions under NAFTA's chapter 6); *see also* Starner,

exempted the "strategic areas" in its energy sector described in the Mexican Constitution.[159] While it is important to respect the sovereignty of each country, the signatories should encourage each other to reach a consensus on these most divisive issues. All of the countries stand to benefit by seeking uniformity in the standards and practices established under NAFTA. The burden should not be borne on Mexico alone; the United States and Canada are equally culpable for protecting their agricultural and mining sectors.[160] Understandably, the world financial crisis has temporarily halted movement in this direction as governments have placed a higher priority on their struggling domestic industries.[161] Nevertheless, international competition from other regions of the world should inevitably provide an incentive for all NAFTA parties to devise a mutually beneficial compromise with respect to these industries, and create the political-economic space for the Mexican government to reevaluate the benefits of Pemex's privileged status under the chapter 6 provisions.

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supra note 135, at 433 (addressing the implications of the chapter 6 provisions under NAFTA).

159. *See* NAFTA *supra* note 133, annex 602.3(1)(b) (Mexico reserves to itself "foreign trade; transportation, storage and distribution, up to and including the first hand sales of . . . natural and artificial gas . . . ."); *see also* Homant, *supra* note 14, at 253 (describing Mexico's energy related activities protected under chapter 6 of the NAFTA); *see also* Murphy, *supra* note 12, at 90-91 (listing the Mexico's reservations under NAFTA chapter 6).

160. *See* Gary N. Horlick & Alicia L. Marti, *Investor–State Arbitration: Reservations and Exceptions*, *in* NAFTA LAW AND BUSINESS, Chapter VI 15, 16 (Ralph H. Folsom & W. Davis Folsom eds., 2000) (explaining the reservations of each NAFTA member state under chapter 6); *see also* Hillary E. Maki, Note, *Trade Protection vs. Trade Promotion: Are Free Trade Agreements Good For American Workers?*, 20 ND J.L. ETHICS & PUB POL'Y 883, 889, 905 (2006) (describing the United States' protectionist measures towards its steel and agricultural sectors).

161. *See* Hi-Taek Shin, *Trade, Investment and Dispute Settlement: The Domestic Decisionmaking Process and Its Implications for International Commitments: American Beef in Korea*, 34 YALE J. INT'L L. 567, 567 (2009) (illustrating how globalized economic markets are susceptible to domestic political pressure); *see also* Ken Ellingwood, *Calderon Reports Gains in Drug Fight*, L.A. TIMES, Sept. 2, 2009, at A17 (describing how the Calderón administration responded to the global economic crisis with increased public works and public lending).

III. *RECOMMENDATIONS FOR PEMEX REFORM*

President Calderón has successfully allowed more private participation in the oil sector without a constitutional fight,[162] but many experts believe the courts will ultimately strike down any hydrocarbon-related legislation further expanding foreign participation through risk contracts so long as Articles 27 and 28 of the Constitution remain unchanged.[163] The evolution of Brazil's state-controlled oil company Petrobras appears to be viable blueprint for Pemex.[164] Following this model will require coalition building across political parties to (1) amend the Constitution to take oil related activities outside of the "strategic areas" exclusive to the Mexican State under Articles 27 and 28,[165] and (2) amend NAFTA by rescinding the Mexican oil sector's privileged status under chapter 6 of NAFTA.[166] In light of the Mexican oil sector's political and legal restraints to FDI,[167] any successful Pemex reform will likely depend on the Mexican government's ability to align the interests of foreign investors, politicians, and their constituencies. This is politically feasible only if increased production correlates with increased government revenue to ease the Mexican people's fear of losing control of Pemex, a symbol of national sovereignty.[168]

President Zedillo's deregulatory model for the electric power sector may also provide the government a way to modernize Mexico's oil sector at a controlled rate, while giving foreign companies the opportunity to satisfy the public's

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162. See *supra* notes 57-58and accompanying text (explaining the objectives of the 2008 Pemex legislation).

163. *See supra* notes 89-95 and accompanying text (analyzing the legal consequences of the Mexican Supreme Court's ruling).

164. *See supra* notes 106-113 and accompanying text (providing the three-stage model for oil reform in Mexico).

165. *See supra* notes 89-95, 106-107 and accompanying text (assessing the legal measure required to allow the necessary degree of foreign activity in Mexico's oil sector to revive Pemex).

166. *See supra* notes 158-159 and accompanying text (explaining Mexico's exemption for "strategic areas" and suggesting the steps Mexico should take under NAFTA to encourage participation from foreign oil companies in the United States and Canada).

167. *See supra* notes 42-62 and accompanying text (explaining the history of and legal challenges to FDI, and the efforts to remove restrictions on FDI).

168. *See supra* notes 2-15 and accompanying text (illustrating the Pemex's centrality to the Mexican economy and society).

expectations based on their ability to increase oil production.[169] This would similarly require three stages: (1) permitting foreign companies to produce oil and sell directly to the government as an IPP;[170] (2) allowing foreign companies to sell oil directly to customers in the wholesale market;[171] and (3) giving foreign companies complete control over their activities in specified territorial blocks that carry tax burdens.[172] In the initial phase, lawmakers could create a state-controlled distribution and regulatory regime, similar to Petrobras' ANP, to monitor Pemex's exploration, production, and refining companies.[173] Taking after the IPP model, foreign investors would then be allowed to finance their own exploration and production in Mexican reserves on the condition that they sell the oil they produce at the rate established by this new regulatory regime.[174] Pursuant to President Calderón's initial proposal, companies would retain ownership over oilrigs and refineries that they construct and finance.[175]

Mexicans may be concerned that deregulating the oil sector would lead to the same results of the electric power sector reform in 1992, where ninety percent of all private investment came from foreign sources.[176] The majority of private investment in the oil sector likely will come from foreign entities since international companies from industrialized nations typically have the financial resources and technical knowledge to perform these sophisticated contracts.[177] This is an unavoidable

169. *See supra* notes 81-85 and accompanying text (providing a method to ease political anxiety over foreign activity in Mexico's oil sector).

170. *See supra* note 75 and accompanying text (applying the IPP model used in the power electric sector to the oil sector).

171. *See supra* note 89 and accompanying text (applying President Fox's power electric reform proposal to the oil sector).

172. *See supra* note 107 and accompanying text (referring to Petrobras' current regulatory regime governing foreign activity in their oil sector).

173. *See supra* note 108 and accompanying text (recommending that the Pemex create a regulatory regime after Brazil's ANP to regulate the Mexican oil sector's gradual opening to foreign companies).

174. *See supra* note 74 and accompanying text (adapting the first stage of oil reform after the IPP model in Mexico's power electricity sector).

175. *See supra* note 54 and accompanying text (referring to President Claderón's original refinery ownership provision left out of the October 2008 Pemex legislation).

176. *See supra* note 77 and accompanying text (addressing concerns that a proliferation of FDI in the oil sector will threaten Mexico's economic sovereignty).

177. *See supra* notes 22-23 and accompanying text (describing the general flow of FDI from wealthy industrialized countries to less developed countries).

consequence that most developing countries must face when a state-run monopoly controls a complex sector of the economy for multiple decades.[178] Host governments can protect themselves by requiring foreign companies to train local employees and place them in sophisticated technical positions.[179] This would protect Mexico's oil sector in the event foreign companies no longer see a profit incentive to remain in Mexico, potentially leaving Pemex ill-trained and undercapitalized. These provisions would enable Pemex to retain some of the technical expertise needed to stabilize an economic shift in the Mexico's oil sector.

Expropriation risks in the foreign oil sector always loom when a project requires a large amount of financing upfront.[180] Foreign companies can protect their investments through contractual provisions designed to discourage future expropriations by including clear provisions for international arbitration, and using international assets as collateral against future expropriations.[181] However, as the case in Venezuela demonstrates, the risk of entering a politically volatile oil sector with a history of prior expropriations may still discourage oil companies, which are hesitant to invest substantial resources in large projects on foreign soil.[182] The Mexican government's willingness to settle disputes within an internationally recognized process under NAFTA should provide some assurance for concerned foreign investors.[183] However, the reservations granted in chapter 6 still pose a barrier to reaching the goals of encouraging free trade and fair competition among NAFTA signatories.[184] If the Mexican government is dedicated to

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178. *See supra* note 10-11 and accompanying text (noting the downside to state-controlled monopolies).

179. *See supra* note 24 and accompanying text (listing the potential downsides to FDI).

180. *See supra* notes 119-24 and accompanying text (explaining why FDI in the oil sector has an increased expropriation risk).

181. *See supra* notes 125-29 and accompanying text (summarizing the key contractual provision designed to protect FDI from expropriation).

182. *See supra* notes 122-24 and accompanying text (noting the inherent risk of expropriation in political unstable countries).

183. *See supra* notes 144-48 and accompanying text (explaining Mexico's gradual acceptance of standards set by international customary law while distancing themselves from the provisions outlined in the Calvo Doctrine).

184. *See supra* notes 158-59 and accompanying text (providing the Mexican government's decision to preserve their oil sectors privileged status under NAFTA).

attracting FDI in the oil sector, then it must remove the oil sector's privileged status under chapter 6 of NAFTA.

If the Mexican government is satisfied with the success of the initial oil reform stage, it could advance to the second proposed stage that creates a regulatory framework to facilitate an open, competitive wholesale oil market, as former President Fox proposed for the electric power sector in 2001.[185] In the third and final stage of reform the Mexican government, through its newly created regulatory regime, would begin granting specified territorial blocks to foreign companies to explore, produce, and sell the oil directly to the market.[186] This privilege would be coupled with taxes and export tariffs to sustain the incoming revenue that the government would receive from the sale of Mexican oil.[187] Following the lead of Petrobras, shares in Pemex could eventually become publicly traded to alleviate some of the Mexican government's financial burden on the oil sector, while still allowing the Mexican government to own the majority of the voting shares.[188] Allowing some of Pemex's equity to be bought by private investors would also encourage the Mexican government to maximize profits for its shareholders, which would also be in line with the interests of the Mexican people if increased profits also result in increased revenue for the government to provide social services. Of course all of these steps would depend on the success of incremental reform, contingent on the cooperation between the Mexican government and foreign private investors.

The Supreme Court's decision to invalidate President Fox's 2001 decree puts the legality of virtually any private activity in Mexico's energy sector into question.[189] While this is a serious barrier to further privatization reform in the energy sector, investors might take comfort in the Court's autonomy to rule

185. *See supra* note 89 and accompanying text (using President Fox's energy reform proposal as the model for the second stage of Pemex reform).

186. *See supra* note 107 and accompanying text (recommending that Pemex model after Petrobras' oil sector in the proposed third reform stage).

187. *See id.* (explaining why the Petrobras model allows the Mexican government to sustain a revenue stream from oil sales while deregulating the sector).

188. *See supra* note 113 and accompanying text (citing Petrobras' presence in the stock exchange as a method for the Mexican government to reduce its financial obligations in the oil sector by the third reform stage).

189. *See supra* note 89-95 and accompanying text (noting the constitutional barriers restricting foreign companies from operating in Mexico's energy sector).

against the President on a major political issue.[190] For example, if a reactionary administration began to view NAFTA as a threat to Mexican sovereignty, the administration could try to abandon NAFTA and revert to re-nationalization policies.[191] In the event of such volatile change in Mexico's political landscape, the courts may be seen as one source of stability. More autonomy within the judicial branch should provide greater legitimacy in the eyes of prospective foreign investors.

Yet the Supreme Court's interpretation of Article 27 calls into question the constitutionality of the electric power sector's entire deregulatory scheme.[192] It appears that only a constitutional amendment taking oil outside of the "strategic areas" exclusive to the Mexican state will establish a stable legal environment to attract foreign companies to Mexico's oil sector.[193]

CONCLUSION

The long-term solution to Pemex's financial problems ultimately depends on its ability to reach oil reserves in the deepest waters in the Gulf of Mexico, but the company has little experience exploring these areas.[194] The October 2008 legislation allowed Pemex to hire foreign companies to explore and produce oil with incentive-based contracts, but companies are restricted from owning the oil or their facilities.[195] Private companies are likely not willing to partner with Pemex in the deepwater explorations projects only as a service company if they

190. *See id.* (demonstrating that that while the Supreme Court's ruling jeopardizes the legality of foreign activity in the energy sector, it also appears to be a more stable institution for legal change).

191. *See supra* notes 117-24 and accompanying text (citing Venezuela's oil nationalization regime as a worst-case scenario for foreign investors).

192. *See supra* notes 91- 94 and accompanying text (restating the legal effect of the Supreme Courts interpretation of Article 27 in the Mexican Constitution).

193. *See supra* note 95 and accompanying text (suggesting that only a constitutional amendment will provide the legal certainties for foreign investors looking to invest in Mexico's oil sector).

194. *See supra* note 11 and accompanying text (illustrating the important role foreign companies can play to modernize Mexico's oil sector).

195. *See supra* notes 57-56 and accompanying text (explaining the limited scope of new activity permitted to foreign companies under the October 2008 Pemex legislation).

must also bear a significant financial burden without ownership rights.[196]

Pemex's fate will impact the future of the entire country.[197] If the government is serious in reforming Pemex it will need to amend Articles 27 and 28 of the Mexican Constitution.[198] This will be an incredible challenge for politicians. Mexico no longer has a dominant political party, making constitutional change—which requires consensus building across distinct political parties—notably more difficult.[199] Still, there is great potential to restore this once thriving company back to prosperity, give the Mexican government increased legitimacy, and ensure the livelihood of the Mexican people.

196. *See supra* note 32 and accompanying text (summarizing how President Calderón's initial reform proposal was based on the notion that foreign companies need increased incentives to participate in Mexico's oil sector).

197. *See supra* notes 14-15 and accompanying text (explaining Pemex's important role in the Mexican economy and society at large).

198. *See supra* note 95 and accompanying text (reflecting on the possibilities of energy reform after the Mexican Supreme Court's ruling in Constitutional Controversy 22/2001).

199. *See supra* notes 96-99 and accompanying text (describing the political process required to amend the Mexican Constitution).