THE ENERGY OVERHAUL’S EFFECTS ON MEXICO’S
NAFTA RESERVATIONS CONCERNING INVESTMENTS
IN THE OIL SECTOR

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Abstract: As a consequence of Mexico’s energy overhaul, an interesting debate arises with respect to Mexico’s obligations concerning investments in the oil sector under NAFTA. Some Mexican lawyers and academics have assumed that the legal effects of Mexico’s “NAFTA reservation” concerning investments in the oil sector no longer covers certain prima facie inconsistencies introduced in the new legal framework. The paper presents an overview on NAFTA’s provisions that relate to investments in the energy sector as well as NAFTA’s reservation system. It then goes on to discuss the legal effects of the energy overhaul on Mexico’s NAFTA reservations applicable to the oil sector. By doing so, the paper questions the approach that NAFTA Panels and Parties have given to reservations, and presents an alternative approach regarding their legal nature and interpretation.

Key Words: North American Free Trade Agreement, Investment Law, Reservations, Energy Reform, Mexico

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I. INTRODUCTION

Oil and Mexico’s state-owned enterprise –Petroleos Mexicanos (“PEMEX”)– are a symbol of Mexico’s national identity and sovereignty. However, in 2013 and 2014 the Constitution and the domestic legal framework, respectively, were amended so as to allow private investment, domestic and foreign, in the oil sector after being prohibited for over seven decades. The energy overhaul has radically changed Mexico’s
domestic energy legal framework, and it may also have an impact on Mexico’s international obligations under the investment chapter of the North American Free Trade Agreement (“NAFTA”).

NAFTA’s investment chapter has far reaching liberalizing effects as it grants, in principle, establishment rights to foreign investors in all economic sectors. Nevertheless, the parties were allowed to include in their schedules to Annex I, II, and III reservations in the form of “negative lists” which are subject to a complex system. At the time of NAFTA’s signature, Mexico inscribed its oil sector and domestic measures in three negative lists, thus excluding the said sector from the investment chapter. As explained below, NAFTA’s reservation system contains specific rules regarding the amendments to the non-conforming measures inscribed in the negative lists.

As a consequence of Mexico’s energy overhaul, two main questions arise with respect to Mexico’s international obligations under NAFTA’s investment chapter. One regards the legal status of Mexico’s NAFTA reservations. The other concerns the extent to which NAFTA’s investment chapter disciplines apply to foreign investments in the Mexican oil sector after the 2013 overhaul. It is assumed that Mexico’s NAFTA reservations are no longer producing effects and that Mexico is currently not complying with its international obligations under NAFTA’s investment chapter. It, therefore, remains to be seen whether Mexico’s NAFTA reservations are still producing legal effects and to what extent are investors of a NAFTA party and their investments in the Mexican oil sector covered by NAFTA’s investment chapter.

The article is divided into three chapters. It first analyzes NAFTA’s applicable rules to investments, as well as those provisions that are relevant to investments in the oil sector. Subsequently, the legal nature of a

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2 ibid Article 1108
3 The Annexes are available in: <https://www.nafta-sec-alena.org/Home/Legal-Texts/North-American-Free-Trade-Agreement>
NAFTA reservation and NAFTA’s complex reservation system are unraveled and explained. Lastly, Mexico’s energy overhaul is examined in connection to Mexico’s NAFTA reservations to determine whether they are still producing legal effects, and if so to what extent.

II. INVESTMENT PROTECTION IN THE ENERGY SECTOR UNDER NAFTA

NAFTA constitutes an important “milestone” in the development of international economic agreements as well of international investment law. NAFTA is a regional trade agreement that went beyond contemporaneous free trade and multilateral agreements by introducing, inter alia, specific rules on energy and investment. This chapter will address NAFTA’s provisions that relate to the energy sector to inform the rights investors and investments from a NAFTA party enjoy absent of a reservation.

A. NAFTA CHAPTER 6: ENERGY AND BASIC PETROCHEMICALS

The energy chapter’s scope and coverage applies to measures relating ‘to energy and basic petrochemical goods originating in the territories of the Parties,’ and it extends to investment and to cross-border trade in services that are “associated” with such goods. NAFTA Article 602(2) lists the energy and basic petrochemical goods, e.g. crude oil, gasoline and other hydrocarbons, that fall under the scope of this chapter.

Three "principles" are introduced in article 601 of the energy chapter, and one may argue that they constitute a special object and purpose within NAFTA. Notably, in the first principle the Parties confirm the "full respect for [a party’s] constitution[."] This principle naturally entails that investment and trade liberalization in the energy sector may be limited by a Party’s constitution. In the second principle the Parties recognize “that it is desirable to strengthen the important role that trade in energy and basic petrochemical goods plays in the free trade area and to enhance this role through sustained and gradual liberalization.” Parties thus view trade liberalization in the energy sector vital for creating a competitive region, but they are

5 Nicola W Ranieri, ‘NAFTA an Overview’ in Leon E Trackman and Nicola W Ranieri (eds), Regionalism in International Investment Law (OUP, 2013) 90
7 NAFTA (n 1) Article 602(1)
8 ibid, Article 601
9 ibid, Article 601(1)
aware that full integration of the North American market is a long-term and gradual objective.\textsuperscript{10} In the third principle the Parties “recognize the importance of having viable and internationally competitive energy and petrochemical sectors to further their individual national interests.”

The three principles reflect the failure of fully integrating the North American energy market, since Mexico exempted itself from most of the scope of the chapter through annexes.\textsuperscript{11} In fact, the first principle suits perfectly Mexico’s interests because when NAFTA was adopted the Mexican constitution prohibited private parties to engage in virtually all activity related to the oil and energy sector.\textsuperscript{12} Furthermore, in accordance with article 31(2) of the Vienna Convention on the Laws of Treaties these principles may serve as an interpretative guide applicable to the provisions contained not only in this chapter, but also for the provisions of the investment and services chapters as well as NAFTA’s annexes, when, for instance, an investment relates to energy and basic petrochemical goods. This position is supported by the interpretive consideration of the Tribunal in ADF v United States, by stating that “specific provisions of a particular Chapter need to be read, not just in relation to each other, but also in the context of the entire structure of NAFTA if a treaty interpreter is to ascertain and understand the real shape and content of the bargain actually struck by the three sovereign Parties.”\textsuperscript{13}

NAFTA’s energy chapter created a special regime for international trade of energy and basic petrochemical products. The same is not true for investment and services. Although the scope of the energy chapter expressly includes measures relating to investment and services, the provisions of this chapter neither create a special investment and services regime nor introduce different or additional substantive rules than

\begin{itemize}
\item \textsuperscript{10} ibid, Article 601(2)
\item \textsuperscript{11} Rios and Poretti (n 6) 345, 357-359
\item \textsuperscript{12} Articles 25, 27 and 28 of the Mexican Constitution prior the DECRTO por el que se reforman y adicionan diversas disposiciones de la Constitución Política de los Estados Unidos Mexicanos, en Materia de Energia D.O.F. 20 December 2013; Article 25 (fourth paragraph) provided “The public sector shall be in charge, in an exclusive manner, of those strategic areas established in Article 28, paragraph fourth of the Constitution, and the Federal Government shall at all times maintain ownership and control over the entities which may be established, as appropriate.”; Article 28 (fourth paragraph) provided “The functions performed in an exclusive manner by the State in the following strategic areas shall not constitute monopolies: [...] petroleum and any other hydrocarbons; basic petrochemical[...]. The State, by exercising its direction over them, shall protect the security and sovereignty of the Nation[...].” Laura Martín del Campo Steta et al., Political Constitution of the United Mexican States, (second edition, Suprema Corte de Justicia de la Nacion, 2008) available at <https://www.scjn.gob.mx/leyes/Documents/Political_Mexican_States_2008.pdf>; for Article 27 see fn 99
\item \textsuperscript{13} ADF Group Inc v United States, Award, 9 January 2003, 18 ICSID Review-FILJ (2003) [149]
\end{itemize}
those contained in their respective chapters; however, it is argued that the only provision of the energy chapter that "discretely" relates to investments is Annex 602.3 NAFTA,\textsuperscript{14} which in its relevant parts provide:

Reservations

1. The Mexican State reserves to itself the following strategic activities, including investment in such activities and the provision of services in such activities:
   a) exploration and exploitation of crude oil and natural gas; refining or processing of crude oil and natural gas; and production of artificial gas, basic petrochemicals and their feedstocks and pipelines;
   b) foreign trade; transportation, storage and distribution, up to and including the first hand sales of the following goods:
      (i) crude oil,
      (ii) natural and artificial gas,
      (iii) goods covered by this Chapter obtained from the refining or processing of crude oil and natural gas, and
      (iv) basic petrochemicals;

In the event of an inconsistency between this paragraph and another provision of this Agreement, this paragraph shall prevail to the extent of that inconsistency.

In Annex 602.3(1) Mexico reserved its right to perform investments in a list of upstream and midstream activities related to the oil sector, and also established a superior norm in case of a conflict of norms. In addition, Annex 602.3(2) states that “[P]ursuant to Article 1101(2), (Investment-Scope and Coverage), private investment is not permitted in the activities listed in paragraph 1.” Although Annex 602.3, paragraph (1) and (2) do not expressly refer to Mexico’s constitution or law, they clearly reflect Mexico’s energy legal framework at the time NAFTA was being negotiated. It is noted that Annex 602.3 is silent on the possibility that Mexico’s energy regime might eventually evolve and allow “private investment.” NAFTA’s Chapter 11 and its related annexes shed light on this issue.

B. CHAPTER 11: INVESTMENT

Chapter 11 NAFTA virtually constitutes an international investment agreement that reflects the agenda of capital-exporting countries with respect to the facilitation of foreign investment in a capital-importing country.\textsuperscript{15} NAFTA’s investment chapter introduces rules that seek to remove and reduce foreign investment barriers, foster an environment of confidence and stability for long-term investments with a predictable and

\textsuperscript{14} It is argued by Rios and Poretti that it is difficult to determine to what extent the provisions of this chapter apply to investments and service see Rios and Poretti (n 6) 358

\textsuperscript{15} Jeswald W Salacuse, The Law of Investment Treaties (OUP, 2010) 101
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transparent framework, and create fair means for the settlement of disputes. 16 NAFTA’s investment chapter’s scope is broad as it covers, in principle, all economic sectors. 17 It is therefore relevant to provide a brief overview of the main features of NAFTA’s investment chapter, which will assist one to determine the legal status of Mexico’s NAFTA reservations.

1. Scope and Coverage

In accordance with article 1101 NAFTA, all measures that relate to investors and investments of another party in the territory of a party are subject to NAFTA’s investment chapter disciplines. 18 In a similar vein, NAFTA defines the terms “investor” and “investment” broadly. UNCTAD notes that the scope of the definitions is relevant to determine the normative content of the investment chapter since there is an interplay between the definitions and the other provisions of the agreement. 19 Investors under NAFTA include not only those who have made an “investment”, but the term stretches to prospective investors and state enterprises, such as PEMEX, 20 while the term “investment” adopts an “asset-based” definition that includes virtually all investments. 21

Despite the apparent extensive scope, it is often overlooked that the broad scope of NAFTA’s investment chapter is subject to qualifications and limitations. 22 Such qualifications and limitations serve as an important counterbalance of NAFTA’s far-reaching liberalizing effects, allowing the NAFTA parties, for instance, to refuse market access to foreign investors in certain economic sectors that may be considered “beyond the

16 ibid
17 Friedl Weiss, ‘Trade and Investment,’ in Peter Muchlinski, Federico Ortino and Christoph Schreuer (eds), The Oxford Handbook of International Investment Law (OUP, 2008) 210
18 NAFTA (n 1), Article 1101(1)(a),(b),(c). Article 201(1) NAFTA provides that the term “measure”, includes any law, regulation, procedure, requirement or practice, and it has been held that a measure relates to an investor or investment when it has a significant legal connection. Conversely, a measure is not considered relating to an investor or investment when it produces a mere effect on an investor or investment. see Methanex Corporation v United States of America, Partial Award, 7 August 2002, UNCITRAL Case at [147]
20 NAFTA (n 1) Article 1139
21 Rios and Poretti (n 6) 351-352
22 For further information on the qualifications and limitations of NAFTA’s investment chapter see James McIlroy, ‘NAFTA’s Investment Chapter: An Isolated Experiment or a Precedent for a Multilateral Investment Agreement’ (2002) vol 3 World Investment Journal 134
reach of liberalization measures” due to, inter alia, cultural, political, national security, or historical grounds.23

In this regard, article 1101(2) NAFTA is of particular relevance for the present analysis, since it limits the scope of the investment chapter by recognizing that “a party has the right to perform exclusively economic activities set out in Annex III and to refuse the establishment of investments in such activities”. Mexico was, in fact, the only NAFTA party that inscribed economic activities under Annex III, which is entitled “Activities Reserved to the State”. In the said annex, Mexico reserved the “right to perform exclusively economic activities and to refuse to permit the establishment of investments […]” in ten economic sectors, including the oil sector. This annex will be further analyzed below.

In a similar vein, article 1108 NAFTA, entitled “Reservations and Exceptions”, introduced a detailed reservation system allowing the Parties to exclude or limit the applicability of the investment chapter’s disciplines to economic sectors and measures. All NAFTA parties have partially or totally carved out economic sectors, sub-sectors or activities from the scope of NAFTA’s investment chapter. They have done so by formulating “NAFTA reservations,” which are found in a Party’s schedules to an annex. The reservation system will be explained in the next chapter.

2. Full Liberalization Model

One of the main features of NAFTA’s investment chapter is its “full liberalization” model.24 A full liberalization model, in theory, opens all economic sectors to foreign investors and their investments.25 NAFTA grants national and most-favored-nation treatment to all investors and their investments at the pre-entry and post-establishment stage unless otherwise provided.26 Article 1104 NAFTA introduces a combined standard of treatment allowing foreign investors and their investments to enjoy either the national or the most favored nation treatment, whichever is better. Therefore, NAFTA ex-ante seeks to remove and prevent all foreign investment entry barriers, allowing foreign investors to make decisions purely on economic

23 Ranieiri (n 5) 102; UNCTAD, International Investment Agreements: Key Issues (n 19) 85
24 Ignacio Gómez-Palacio and Peter Muchlinski, ‘Admission and Establishment,’ in Peter Muchlinski, Federico Ortino and Christoph Schreuer (eds), The Oxford Handbook of International Investment Law (OUP, 2008) 243
25 Weiss (n 17)
26 ibid; Gómez-Palacio and Muchlinski (n 24) 240-242
grounds. From an ex-post perspective, NAFTA limits a party’s ability to treat established investments differently on the grounds of the nationality of its owner.

a) Investor’s Rights

Investors of NAFTA parties and their investments enjoy rights that can be categorized into two groups. The first group is relative rights, namely the national and most-favored-nation treatment, because they are linked to the treatment that is accorded to domestic and third country investors and investments that are in like circumstances. The second group is absolute rights since they prevent or limit a NAFTA party to adopt or maintain certain measures that affect already established investments even if they “are applied equally to that [party’s] nationals”. Investors under NAFTA enjoy the following five absolute rights:

(i) a minimum standard of treatment, which includes fair and equitable treatment and full protection and security;

(ii) the prohibition to impose or use specific performance requirement, e.g. domestic content requirements, transfer of technology in the establishment of investments, and prefer goods and services of national origin;

(iii) the prohibition to expropriate without fulfilling four cumulative conditions, namely for a public purpose, on a non-discriminatory basis, in accordance with due process and the minimum standard of treatment, and on payment of compensation;

(iv) the right to freely control an investment; and,

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28 For further information on this subject see McIlroy (n 22); Todd Grierson-Weiler and Ian A Laird, ‘Standards of Treatment’ in Peter Muchlinski, Federico Ortino and Christoph Schreuer (eds), The Oxford Handbook of International Investment Law (OUP, 2008); Sergio Puig and Meg Kinnear, ‘NAFTA Chapter Eleven at Fifteen’ (2010) 25(2), ICSID Review—FILJ 242 <http://ssrn.com/abstract=1859466> accessed 12 January 2016
29 McIlroy (n 22) 136
30 ibid
31 ibid
32 ibid 137-142
33 NAFTA (n 1) Article 1105
34 ibid, Article 1106(1) and (3)
35 ibid, Article 1110
36 ibid, Article 1107
(v) the right to freely transfer capital and without delay.\textsuperscript{37}

\section*{III. NAFTA RESERVATIONS}

As noted above, NAFTA’s investment chapter has a full liberalization model that extends to all economic sectors. Certain economic sectors, however, may be “beyond the reach of liberalization measures” for a particular State.\textsuperscript{38} Under NAFTA, the parties are allowed to refuse market access to foreign investors in certain sectors as they may be considered sensitive due to, inter alia, cultural, political, national security, or historical grounds.\textsuperscript{39} All NAFTA parties have partially or totally carved out economic sectors, sub-sectors or activities from the scope of NAFTA’s investment chapter. They have done so by formulating “NAFTA reservations,” which are found in a Party’s schedules to an annex. This chapter will carefully examine the operation of NAFTA’s reservation system and the legal nature of “NAFTA reservations”. Such examination will assist the determination of the legal status and scope of Mexico's NAFTA reservations concerning investments in the oil sector.

\subsection*{A. NAFTA RESERVATION SYSTEM REGARDING INVESTMENT}

Under NAFTA's investment chapter a party may exclude or restrict foreign investment from economic sectors or activities through “schedules.” NAFTA’s investment chapter develops a detailed reservation system, which serves as an important counterbalance of the chapter’s far-reaching liberalizing effects. The reservation system established in article 1108(1) NAFTA only allows the parties to exclude the application of articles 1102 (national treatment), 1103 (most favored nation treatment), 1106 (performance requirements), and 1107 (senior management and boards of directors) NAFTA. The reservation system can be explained in the following manner:

(i) the parties reserved their right to maintain existing non-conforming measures provided that they inscribe such measures and economic sectors and also specify the obligation for which a reservation is taken in their schedules to Annex I. The listed measures include “any subordinate measure adopted or maintained under the authority of and consistent with the measure[ ]”\textsuperscript{40}

\textsuperscript{37} ibid, Article 1109
\textsuperscript{38} UNCTAD, International Investment Agreements: Key Issues (n 19) 85
\textsuperscript{39} Ranieri (n 5) 102
\textsuperscript{40} NAFTA (n 1) Article 1108(1) (a) (ii, iii) and Annex I (2)(f)
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(ii) the parties reserved their right to maintain or adopt new or more restrictive measures in economic sectors provided that they inscribe measures and sectors in their schedules to Annex II[41]

(iii) recognized a party’s right, namely Mexico, to perform exclusively the activities listed in its schedule to Annex III and to refuse the establishment of investments in activities related to, inter alia, petroleum, electricity, and nuclear power. Unlike Annex I, the measures listed therein are only for the purpose of transparency. However, the listed measures include any subordinate measure as in Annex I[42]

For a measure to be considered “subordinate” and, thus, covered by a measure listed in a schedule of Annex I and III, it must meet two conditions or qualifying elements, given that a the terms “adopted or maintained” catch all (subordinate) measures, those that existed before NAFTA’s entry into force as well as those that later came into existence. The first condition, “under the authority of the measure”, is, as the term “subordinate” suggests, a measure that derives from and is hierarchically inferior to the listed measure; or in words of the majority in Mobile & Murphy, “it is the reserved measure that provides the legal basis or origin of the subsequent measure[.]”[43] Obvious examples would be the regulation of a law or general administrative rulings, since the law may recognize or even order their existence. The third condition is more complex as it involves a “consistency” test, which was discussed in Mobil & Murphy, a dispute that involved a Canadian reservation and a new subordinated measure. The majority of the arbitrators in that dispute held that pursuant Annex I(2)(f) a new subordinate measure shall not only be consistent with the non-conforming measure at issue, but it should also be consistent with the non-conformity level of other existing or previous subordinate measures, because “once a subordinate measure meets the test of authority and consistency with the reserved measure under paragraph 2(f)[Annex I], it can then become part of the legal framework of “the measure” for purposes of evaluating new subordinate measures.”[44] The dissenting

[41] ibid, Article 1108(2)
[42] ibid, Articles 1101(2) and 1108(1)(i) and Mexico’s schedule to Annex III section A(1)
[44] ibid [332]; Annex I(2)(f) NAFTA (n 1) provides that “Each reservation sets out the following elements: [...] (f) Measures identifies the laws, regulations or other measures, as qualified, where indicated, by the Description element, for which the reservation is taken. A measure cited in the Measures element: (ii) includes any subordinate measure adopted or maintained under the authority of and consistent with the measure; [...]”

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The NAFTA reservation system described above has five main features. First, article 1108(1) NAFTA only allows a party to exclude the legal effects of certain provisions, while articles 1105 (minimum standard of treatment) and 1110 (expropriation) are not subject to reservations. Second, the schedules to Annexes I, II, and III list measures and economic sectors that fall outside the scope of NAFTA’s investment chapter.

Third, in Annex I and II, on the one hand, the parties established requirements regarding the “elements” that a reservation in a schedule must contain as well as interpretative rules. According to paragraph 2 of Annex I, for instance, a Party must identify in their reservation (a) sector, (b) subsector, (c) industry classification, (d) type of reservation (i.e. the obligation), (e) level of government, (f) laws, regulations or other measures for which the reservation is taken, (g) description, and (h) whether the reservation is subject to a phase-out commitment. As for interpretative rules, Parties agreed that all elements of the reservation shall be considered and that it shall be interpreted in the light of the relevant provisions of the Chapters against which the reservation is taken; however, such interpretative rules are subject to the following qualifications:

- (a) the Phase-Out element provides for the phasing out of non-conforming aspects of measures, the Phase-Out element shall prevail over all other elements;
- (b) the Measures element is qualified by a liberalization commitment from the Description element, the Measures element as so qualified shall prevail over all other elements; and
- (c) the Measures element is not so qualified, the Measures element shall prevail over all other elements, unless any discrepancy between the Measures element and the other elements considered in their totality is so substantial and material that it would be unreasonable to conclude that the Measures element should prevail, in which case the other elements shall prevail to the extent of that discrepancy.

Annex III, on the other hand, does not provide specific rules regarding the content of a reservation or its interpretation. It is argued that Annexes I and II required a much higher degree of detail to ensure transparency and predictability, whereas the unique nature of reservations introduced in Annex III, i.e.

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46 ibid, Article 1108(1)
activities reserved to the state, allowed Mexico, the only party to submit such type of reservations, not to specify the exact scope of the non-conforming measures.47

Fourth, the non-conforming measures inscribed in the schedules to Annexes I and III are subject to two relevant rules regarding their “existence”. The first rule, introduced in article 1108(1)(b), allows a party to continue or replace their measures without losing their reserved right.48 The second rule, contained in article 1108(1)(c), is known as the “ratchet clause” because it prevents a party to increase the level of non-conformity of its measures “as it existed before its last amendment [...].”49 This clause does not prohibit a party to decrease the non-conforming aspects of an inscribed measure, nevertheless, it has the effect of establishing a new non-conformity level once a party has amended its inscribed measure towards conformity with NAFTA’s substantive obligations. As the non-conformity level of a measure decreases, the effects of the obligation for which the reservation was taken would flourish and apply to the extent of the new non-conformity level established in the amendment. By preventing a party to increase the non-conformity level of its measures, the ratchet clause therefore has the purpose of gradually lowering the non-conforming aspects of the measure towards complete compliance with NAFTA’s substantive obligations.

Finally, Mexico’s NAFTA reservations inserted in its schedule to Annex III are subject to a hierarchy rule established in Annex 602.3 NAFTA. In Annex 602.3(1) NAFTA, Mexico introduced a NAFTA reservation that applies to investments in upstream and midstream oil activities, and such reservation prevails in the event that another provision conflicts with it.

B. THE LEGAL NATURE OF A NAFTA RESERVATION

According to article 2(1)(d) of the Vienna Convention on the Law of Treaties (VCLT), a "Reservation" means:

> a unilateral statement, however phrased or named, made by a State, when signing, ratifying, accepting, approving or acceding to a treaty, whereby it purports to exclude or to modify the legal effect of certain provisions of the treaty in their application to that State.

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47 UNCTAD, Preserving the Flexibility of Treaties in IIAs: The Use of Reservations (UNCTAD/ITE/IIT/2005/8, United Nations, 2006) 26
48 NAFTA (n 1) Article 1108(1)(b)
49 Alexandre Genest, ‘Mobil Investments v Canada: A Blow to Policy Space and Predictability for Measures Subject to Reservations’ (2014) vol 29 no 2 ICSID Review at 308
From the above-mentioned definition, it is possible to note that a reservation has three elements. First, a reservation derives from unilateral statement. Second, this unilateral statement is made when a State express its consent to be bound by a treaty. Third, the function or object of a reservation is to exclude or to modify the legal effect of certain provisions of the treaty in their application to the reserving State.\textsuperscript{50} The definition of a reservation, however, falls short, as it leaves out two crucial elements that are essential for a reservation to purport its effects, namely it must either be accepted or not opposed by the other parties and it is must be “permissible”.\textsuperscript{51} Needless to say, parties can expressly authorize specific reservations and, as a general rule, such reservations would not require any subsequent acceptance by the other contracting parties, in accordance with articles 19 and 20(1) VCLT.

A reservation is an expression of sovereignty.\textsuperscript{52} This is so because a reservation is individually introduced by a State and its intended effects. Though a reservation derives from a unilateral statement, the legal nature of a reservation, nevertheless, is considered to be a non-autonomous unilateral act. It is a non-autonomous unilateral act since a reservation that produces legal effects (i.e. an established reservation) has been either expressly authorized by the parties, or it has been accepted or not objected by the other contracting parties.

As for the intended effects, by formulating a reservation, a State escapes from or limits the legal effects of an international obligation introduced in a treaty norm, thereby preserving its customary rights.

NAFTA's Annexes I, II, and III and a party’s schedule include in their title the term “reservations” and were submitted unilaterally by the NAFTA parties,\textsuperscript{53} the reservations introduced in the schedules are not per se reservations in the sense of the VCLT. In article 2201 NAFTA, it is established that all annexes to NAFTA, such as Annexes I, II and III, are an integral part of the agreement.\textsuperscript{54} Hence, NAFTA reservations, at first glance, appear to be a conventional technique because the Parties agreed beforehand in the exact content of their reserved rights,\textsuperscript{55} it is in this regard that NAFTA reservations differ from a traditional VCLT

\textsuperscript{51} VCLT (n 50) Articles 20 and 21; ILC (n 50) 287, 433, 454
\textsuperscript{53} Articles 19, 20 and 12 VCLT
\textsuperscript{54} Mobil & Murphy (n 43) [254],[340]
\textsuperscript{55} NAFTA (n 1) article 2201; cf Isabelle Van Damme, Treaty Interpretation by the WTO Appellate Body (OUP, 2009) 103-107,109
\textsuperscript{56} ILC (n 50) 123 [12]-[13]
reservation. Under the VCLT, if a clause expressly authorizes “specific” reservations, it would allow a State to make a reservation and define the limits of thereof; however, they “are not ‘reservations’ at all in the proper sense of the term, but reservation clauses [...].”

Notwithstanding that NAFTA reservations constitute an integral part of the agreement, they should be equated to VCLT reservations. According to Guideline 1.1.6 of the Guide to Practice on Reservations to Treaties, unilateral statements formulated by a Party, when expressing its consent to be bound by a treaty, that purport to exclude or modify the legal effect of provisions, pursuant a clause that expressly authorizes such possibility, “constitutes a reservation expressly authorized by the treaty.” NAFTA reservations fulfill each of these elements. First, NAFTA reservations are connected to a reservation clause, i.e. article 1108 NAFTA, which permitted each party to exclude the application of certain provisions to specific measures and economic sectors. Second, a Party freely submitted its NAFTA reservations in its schedules, which were not subject to formal negotiations. Third, NAFTA reservations were an essential element for the conclusion of NAFTA that were submitted at the time signing. Fourth, NAFTA reservations share the same purpose as a VCLT reservation, i.e. to exclude or modify the effects of a legal provision. Indeed, it seems that there are no cogent reasons that NAFTA reservations should not be treated differently from VCLT reservations.

In Mobil & Murphy there was an ample discussion about how should a NAFTA reservation be interpreted, a question that is intrinsically related to its legal nature. At the outset, the Tribunal in that case found that all NAFTA parties appear to agree that NAFTA reservations should be interpreted in accordance with the customary rule of treaty interpretation as reflected in articles 31 and 32 VCLT. Though the majority and dissenting arbitrators in Mobil & Murphy recognized the unilateral nature of NAFTA reservations, the majority considered Canada’s reserved measure at issue as a “commitment” that is an integral part of the agreement, and it concluded that the customary rules of treaty interpretation applied;
the dissenting panelist, on the other hand, did not criticize the application of article 31 VCLT. Though the majority stated that it would interpret the reservation in a balance manner, it is argued that the majority relied on the NAFTA’s overarching objectives when interpreting the criterion “consistent with” and the term “measure” found in Annex I (2)(f)(ii). As mentioned above, the majority considered that a new subordinate measure must be consistent with the non-conformity level of other existing or previous subordinate measures, i.e. the measure. By doing so, it relied heavily in articles 1106 and 1108, as context, and NAFTA’s objective “increase substantially investment opportunities in the territories of the Parties”.

Even though NAFTA has a full liberalization model and reservations are subject to specific disciplines, one may validly question the decision of the Majority in Mobile & Murphy of considering and treating a NAFTA reservation as a “commitment” and relying heavily in NAFTA’s liberalizing objectives. Viñuales notes that commentators and practitioners have disregarded the fact that investment agreements are “a narrow exception to the general customary rule stated in Resolution 1803(XVII), i.e. permanent sovereignty over natural resources”; such customary rule entails that the exploration, development and disposition of natural resources, as well as the import of foreign investment, should be in conformity with a State’s domestic laws, and such customary rule in Resolution 3201(S-VI) has been further expressed so as to include “economic activities” and their “effective control.” Consequently, international investment agreements intend to limit such customary rights; nevertheless, and according to Viñuales, the interplay between customary international law and investment treaties must be examined carefully.

Given the above, there is a manifest dichotomy between the articulation and structure of NAFTA’s investment chapter and general customary law, in particular the full liberalization model vis-à-vis the right to deny and restrict foreign investment. It is absurd to assume, as the majority did in Mobile & Murphy, that a NAFTA reservation constitutes a commitment since the purpose of a reservation is completely the

64 Mobil & Murphy (n 43) [340]-[341], [343]
65 Jorge E. Viñuales, ‘Sovereignty in Foreign Investment Law’ in Zachary Douglas, Joost Pauwelyn, and Jorge E. Viñuales (eds), The Foundations of International Investment Law: Bringing Theory into Practice (OUP, 2014) 319; the International Court of Justice recognized the permanent sovereignty over natural resources as customary rule in Armed Activities on the Territory of the Congo (Democratic Republic of the Congo v Uganda), Judgment, ICJ Reports 2005 [244]; see also Gómez-Palacio and Muchlinski (n 24) 228; Weiss (n 17) 319
66 UNGA Res 1803 (XVII) (14 December 1962), [2]
67 UNGA Resolution 3201(S-VI)(1 May 1974) [4(e)]
68 Viñuales (n 65)
opposite. A reserving Party is not committing itself, unless its reservation is subject to a phase-out or liberalization commitment. Moreover, if a NAFTA reservation were considered as a commitment, it would mean that it creates opposable rights by virtue of a treaty, such as the right to deny market access to foreign investors, which is ridiculous as a reserving Party already enjoys those rights under customary law. Hence, a NAFTA reservation must not be seen as a commitment or an agreed exception to a party’s liberalization commitments, but rather as an expression of preserving its “customary” sovereign right to regulate foreign investment and economic activities.69

Some hold that the conventional nature embraced by alternatives to reservations, such as supplementary agreements concluded between parties, “precludes any equation with [VCLT] reservations.”70 If such approach is accepted and reservations are considered as commitments, as in Mobil & Murphy, one would be compelled to interpret a NAFTA reservation in accordance with the customary international rules of treaty interpretation. One must point out that the purpose of the general rule of treaty interpretation is to assert the common intention of the parties and not of one party.71 Other elements distinct from the text of a NAFTA reservation that may assist an interpreter to determine the intention of the reserving party, such as the circumstances of its formulation and other exogenous elements, may be neglected if it is deemed that the interpretation pursuant article 31 VCLT is not ambiguous or absurd.72 Given that it is undisputed that NAFTA reservations are unilateral submissions that were submitted at the time of manifesting their consent, it would be unreasonable not to equate a NAFTA reservation introduced in the schedules to Annex I, II, and III (as well as Annex 602.3) to VCLT reservations.73 As a consequence, logic dictates that one should interpret their text by reference to the intention of the reserving NAFTA party because there is a notorious “disconnect,” similar to that of a VCLT reservation, between the common intention of the parties and the reserving party.74

The legal nature of a NAFTA reservation is neither purely conventional nor unilateral, but rather “eclectic”. This is so because they came into existence through unilateral submissions that were authorized

69 ibid; cf Mobil & Murphy (n 43) [340]
70 ILC (n 50) 129 [23]
72 VCLT (n 50) Article 32 ; ILC (n 50) 467-472
73 NAFTA (n 1) Article 102(2); ILC (n 50) 59-60 [8]
74 Frank Horn, Reservations and Interpretative Declarations to Multilateral Treaties (North Holland,1988) 261
by a clause, and such unilateral submissions were automatically transformed into an integral part of the agreement by a treaty provision. NAFTA reservations are thus quasi-unilateral, making the customary rule of treaty interpretation inapplicable. In this regard, it is important to note that NAFTA reservation in schedules to Annexes I and II are governed by interpretative rules, while those in Mexico’s schedule to Annex III are not subject to any such rules. If the meaning of a NAFTA reservation is ambiguous or obscure as a result of the interpretative rules or the text itself, recourse shall be made to the rules on the interpretation of VCLT reservations developed by International Court of Justice (“ICJ”) because the decisions of such court serve as subsidiary mean for the determination of the relevant rules of law concerning the interpretation of reservations pursuant Article 38 of Statute of the International Court of Justice.  

C. THE EFFECT OF THE ENERGY OVERHAUL ON MEXICO’S <<NAFTA RESERVATIONS>>

When NAFTA was being negotiated, Mexico refused to open its oil sector to foreign investment and formulated reservations that were rooted in Mexico's legal framework at the time. Foreign investors, however, were allowed to participate in certain activities of the oil sector through service contracts. Their method of payment could only be determined on a fixed value since the standard profit, production and risk sharing agreements used in the sector were prohibited by Mexican Law. In 2008 there was an attempt to open the oil sector to foreign investment and the resulting energy overhaul introduced minor amendments to the investment regime. The limitations to foreign investment, however, were not modified.

Economic circumstances have forced Mexico to liberalize the energy sector to international trade and foreign investment. PEMEX is a pillar of the Mexican economy, but its underperformance has put Mexico’s public finances at risk. Mexico is at the verge of becoming a net oil importer as crude oil production has declined dramatically since mid-2000s because, inter alia, PEMEX was subject to a burdensome tax regime that prevented it from investing in new projects, lacks financial capital, as well as human and technological resources to exploit most of Mexico’s remaining oil reserves that lie in deep waters. In light of this ‘critical’ situation, the government in power has promoted free market policies through Congress with the aim of

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75 Statute of the International Court of Justice, 26 June 1945 (entered into force 24 October 1945) 3 Bevans 1153 Article 38; Hugh Thirlway, ‘The Sources of International Law’ in Malcom D Evans (ed), International Law (fourth edition, OUP, 2014) 94-95, 106
76 OECD, OECD Economic Surveys Mexico 2013 (OECD, 2013) 28
77 ibid
increasing productivity and efficiency in the energy sector. However, as explained below, the new law privileges PEMEX in certain circumstances and arguably conflicts with article 1106 NAFTA.

Given the reservation system established in article 1108 NAFTA, Mexico’s NAFTA reservations are linked to its domestic law and some are subject to the ratchet clause, i.e. article 1108(1)(c) NAFTA. Mexico’s NAFTA reservations in the oil sector appear obsolete because they no longer reflect the current legal framework, but that does not necessarily mean that they are not producing legal effects. This chapter will determine whether Mexico’s NAFTA reservations related to investments in the oil sector are still producing legal effects and if so to what extent.

D. THE ENERGY OVERHAUL IN BRIEF

On December 20, 2013, the relevant constitutional provisions relating to the oil industry, were subject to amendments to allow private investment in the energy sector. Articles 25 and 27 of the Constitution currently allow the State to grant directly “entitlements” to productive state-owned companies (SOEs), e.g. PEMEX, and to execute contracts for the exploration and extraction of oil with private investors and SOEs. 78 Article 28 of the Constitution was amended and no longer provides that the “basic petrochemical industry” is a

78 Article 25 (paragraph five) “The public sector shall exclusively be in charge of those strategic areas established in Article 28, paragraph fourth of the Constitution. The Federal Government shall at all times keep ownership and control over agencies and public productive corporations that have been established. In the case of [...] exploration and exploitation of oil and other hydrocarbons, the Nation shall be empowered to carry on those activities pursuant to paragraphs sixth and seventh of Article 27 of this Constitution.[...].” Article 27 (paragraph seven) “In the case of petroleum and solid, liquid or gaseous hydrocarbons found underneath the surface, dominion by the Nation shall be inalienable and imprescriptible, and no concessions shall be granted. In order to obtain revenue for the State and contribute to the long-term development of the Nation, the State shall explore for and exploit oil and other hydrocarbons through [entitlements] to productive state-owned companies, or through contracts to be executed with them or private parties, in accordance with the implementing law. To fulfill the purpose of said [entitlements] and contracts, the productive state-owned companies may enter into contracts with private parties. In any event, subsoil hydrocarbons shall remain property of the Nation and it shall be so expressed in the allocation and contracts.”(translation by M. Fernanda Gomez Aban, Mexico’s Constitution of 1917 with Amendments through 2015, the Comparative Constitutions Project <https://www.constituteproject.org/constitution/Mexico_2015.pdf?lang=en>) see DECRETO por el que se reforman y adicionan diversas disposiciones de la Constitución Política de los Estados Unidos Mexicanos, en Materia de Energía D.O.F. 20 December 2013
strategic area of the State. Consequently, it allows private investors to participate in the refining, processing, transportation, storage, and distribution of hydrocarbons.

On August 11, 2014, the new energy legislation relating to the constitutional amendment was published. Among other structural amendments, Mexico amended the Foreign Investment Act and replaced the Regulatory Law of Article 27 of the Constitution on Petroleum through the Hydrocarbons Act. Mexico’s domestic legal framework now allows private investors, including foreign, to participate in all activities of the oil sector. The new rules introduced in Mexico’s domestic law will be examined at the light of the provisions of NAFTA’s investment chapter to identify inconsistencies, which will later assist one to determine the legal status of Mexico’s NAFTA reservations.

1. Entitlements and Contracts

According to domestic law, areas for the “exploration” and “extraction” of oil may be subject to entitlements or contracts. Entitlements can be granted only to State Owned Enterprises (SOEs), whereas contracts may be executed with private investors and SOEs. PEMEX, Mexico’s SOE, during the so-called “Round Zero” retained certain areas of oil through entitlements in order to maintain its competitiveness and reserves. The Ministry of Energy may exceptionally grant additional entitlements to PEMEX if it deems that it is necessary to the nation. Under an entitlement, PEMEX can only execute service contracts with private investors and cannot enter into a risk or production sharing agreement, unless the entitlement is

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79 Article 28 (paragraph four) “The functions carried out by the State in an exclusive manner in the following strategic economic sectors shall not be considered monopolistic: post, telegraph, radiotelegraphy; radioactive minerals and nuclear power generation; planning and control of the national power system and the public power transmission and distribution systems; the exploration and exploitation of oil and other hydrocarbons, pursuant to paragraphs six and seven of the 27th Article of this Constitution, as well as any other activity expressly determined by the laws issued by Congress.” ibid

80 Elisabeth Eljuri and Daniel Johnston, ‘Mexico’s energy sector reform’ (2014) 7(2) Journal of World Energy Law and Business 170

81 Exploration means activities that use direct methods, including drilling wells, identification, discovery and evaluation of hydrocarbons in the subsoil, in a defined area; Ley de Hidrocarburos D.O.F. 11 August 2014 (“Hydrocarbons Act”) Article 4(XIV)

82 Extraction means, inter alia, activities aimed towards the production of hydrocarbons; ibid, Article 4(XV)

83 ibid, Articles 6 and 11


85 Hydrocarbons Act (n 81) Article 6
transformed into a contract for the exploration and extraction of hydrocarbons (hereinafter referred as “contracts”).

A contract will be subject to a public and transparent bidding process organized by the National Hydrocarbon Commission (“NHC”). SOEs and private investors may participate individually or through alliances, and the NHC will select the best offer in accordance with the bidding terms. One must emphasize that PEMEX will compete under identical circumstances with private investors in the tenders for contracts. However, certain contracts may require the participation of SOEs. When a contractual area is located in or has the possibility of finding transboundary reservoirs, the SOE must contribute at least with 20% of the investment project. Also, the Ministry of Energy may decide to include in the bidding terms of a contract that the participation of a SOE is required because, inter alia, the contractual area to be tendered coexists, at different depths, with an entitlement area or it may represent an opportunity to promote the transfer of technology.

The Hydrocarbons Act treats more favorably its SOEs than private investors, domestic or foreign, and also grants Mexican authorities discretionary powers to accord additional advantages to SOEs. As noted, SOEs, such as PEMEX, are the only economic agents that can receive an entitlement, thus, they are treated more favorably because entitlements are excluded from tenders in which private investors. By requiring the mandatory participation of SOEs in the bidding terms of a contract, the law also provides more investment opportunities to SOEs than private investors. Given the above, the SOEs receive better treatment than private investors in the establishment and acquisition of investments in the exploration and extraction of oil.

Although Mexico only treats more favorably its SOEs, namely PEMEX, as compared to other domestic investors, a foreign investor only needs to prove that it has been discriminated in comparison to another investor in like circumstances to establish a breach of the national treatment obligation in article 1102 NAFTA. As a consequence of the overhaul, it can be argued that Mexico de jure treats more favorably a

80 ibid, Articles 9, 12, 13 and 19
81 ibid, Articles 15 and 23
82 ibid, Articles 11 and 23
83 ibid, Article 17
84 ibid, Article 16
domestic investor, i.e. PEMEX, than foreign investors that are under like circumstances. Following the approach in Pope & Talbot, one would naturally identify PEMEX as the domestic entity whose treatment will be compared to that accorded to a foreign investor that seeks or is making an investment in the oil sector because both would be in the same “business sector.”92 Foreign investors are accorded different treatment in the establishment and acquisition of investments, because PEMEX may be granted an entitlement or its participation may be required pursuant to the bidding terms of a contract. In other words, a foreign investor would not receive the best treatment that is available to a domestic investor, and therefore it would not enjoy fair conditions of competition.93 At this point, a foreign investor would establish a prima facie breach of Mexico’s national treatment obligation, and the burden of proof would shift to Mexico to justify whether there are grounds not to consider PEMEX and a foreign investor in “like circumstances,”94 or if this discrimination is covered by Mexico’s NAFTA reservation.

2. Performance Requirements

The Hydrocarbon Act provides three performance requirements that are prohibited by NAFTA’s investment chapter. First, the sum of all activities of operators under an entitlement or contract are subject to a minimum percentage of domestic content.95 Article 1106(1)(b) NAFTA expressly prohibits performance requirements that seek to achieve a given percentage of domestic content. Mexico is thus acting prima facie inconsistently with the aforementioned provision.

Second, the Hydrocarbon Act provides that Mexican authorities shall establish in the terms of the entitlements, contracts, and permits that the purchase of goods and services of national origin shall be preferred when they are offered under the “same conditions.”96 Article 1106(1)(c) NAFTA prohibits a party to impose a requirement to investments, either domestic or foreign, to purchase or accord preference to

92 Pope & Talbot (n 91) [78]
93 Pope & Talbot (n 91) [42],[66],[70]; Grierson-Weiler and Laird (n 28) 291
94 Pope & Talbot (n 91)[70],[78]-[79]; Grierson-Weiler and Laird (n 28) 295
95 The total of the activities must achieve 25% of domestic content on 2015, and such percentage will progressively increase up to 35% by 2025; Hydrocarbons Act (n 81) Article 46 and 24th Transitory
96 ibid, Article 128
goods produced or services provided in its territory. Mexico has introduced this performance requirement in contracts, and therefore Mexico is acting prima facie inconsistently with NAFTA.  

Third, and as noted above, the Ministry of Energy can require the participation of PEMEX in the bidding terms of a contract because it may be an opportunity to acquire technology. In turn, article 1106(1)(f) NAFTA establishes that no NAFTA party may impose a requirement, in connection with the establishment or acquisition of an investment, to transfer technology to a person in its territory. Therefore, Mexico would be imposing a prima facie prohibited performance requirement if in the bidding terms of a contract PEMEX’s participation is required on the grounds that it will encourage the transfer of technology to PEMEX.

E. ANNEX I NAFTA

In Mexico’s schedule to Annex I NAFTA there are three reservations applicable to investments related to the oil sector in upstream, midstream and downstream activities. In the three reservations, Mexico reserved only the right to grant national treatment and inscribed as non-conforming measures articles of Mexican Constitution, the Mexican Investment Promotion and Foreign Investment Act and its regulation (which were replaced by the Foreign Investment Act and its regulation), and the Regulatory Law of Article 27 of the Constitution on Petroleum.

1. Upstream Activities

The listed activities were identified as being part of the “construction” sector, but they are related to upstream activities of the oil sector. In the industry classification element, it was inscribed the following: “(CMAP 501322 ) Construction of Means for the Transportation of Petroleum and its Derivatives (limited to specialized contractors only)” and “(CMAP 503008) Petroleum and Gas, Exploration and Drilling Works and Services (limited to specialized contractors only).” The description element provided the following:

Risk-sharing contracts are prohibited.
Prior approval of the Comision Nacional de Inversiones Extranjeras is required for investors of another Party or their investments to own, directly or indirectly, more than 49 percent of the ownership interest in an enterprise established or to be established in the territory of Mexico involved in "non-risk-sharing" contracts for the exploration and drilling works of petroleum and gas wells and the construction of means

for the transportation of petroleum and its derivatives. See also Schedule of Mexico, Annex III, page III-M.1.

It is important to note that the measure element is not qualified by a liberalization commitment. Furthermore, the description element of this reservation indicates the remaining non-conforming aspects of the existing measures for which the reservation is taken, according to Annex I (2)(g). 98

Turning to the first non-conforming aspect of the description element, article 27 of the Constitution and the Regulatory Law of Article 27 of the Constitution on Petroleum prohibited risk-sharing contracts. 99 As a result of the constitutional amendment and the Hydrocarbon Act, PEMEX may now enter into these sorts of agreements only under the figure of “contracts” but not under “entitlements”. 100 The conformity level of Mexico’s listed non-conforming measures regarding Mexico’s national treatment obligation has increased, but it has yet to achieve full conformity.

As for the second non-conforming aspect of the description element, FIA provided in its article 8 (X) and (XI) that a favorable decision of the Comision Nacional de Inversiones Extranjeras (National Commission on Foreign Investment) is required for foreign investors to own more than 49 percent of the ownership interest in an enterprise that engages in activities relating to drilling works of petroleum and gas wells and the construction of means for the transportation of petroleum and its derivatives. As of the date that the energy overhaul came into effect, sections (X) and (XI) of article 8 FIA were eliminated, foreign investors therefore no longer require the approval of the Commission to own more than 49% of ownership interests in an enterprise that engages in the aforementioned activities. Hence, as a result of the amendment to FIA, this non-conforming aspect has been eliminated and, thus, the listed measures have achieved full conformity with article 1102 NAFTA in this regard.

98 NAFTA (n 1), Annex I (2)(g)
99 Article 27 (paragraph six) previously provided in its relevant part “[...] In the case of petroleum and solid, liquid or gaseous hydrocarbons or radioactive minerals, no concession or contract shall be granted, and those previously granted shall no longer exist, and the Nation shall exclusively carry out the exploitation of those products in accordance with the implementing law.” (as amended in D.O.F. 6 February 1975); Article 6, Regulatory Law of Constitutional Article 27 on Petroleum, provided “[PEMEX] and its subsidiaries may execute construction and service contracts with individuals and corporations to improve their activities as so required. The payment of such contracts will always be in cash and in any case the property of the hydrocarbons may be transferred; production-sharing agreements or a contract that compromises the production or the value of the sales of the hydrocarbons or its derivates, as well as profit-sharing, may not be executed.” (as amended in D.O.F. 28 November 2008)
100 Ministry of Energy (n 84)
2. **Midstream and Downstream Activities**

The remaining two reservations are listed as pertaining to the energy sector and the petroleum products sub-sector. Mexico listed in the industry classification element: “(CMA 626000) the retail of Liquified Petroleum Gas (LPG)” and “(CMA 626000) Retail Outlets of Gasoline and Diesel (including lubricants, oils and additives for resale in these retail outlets)”. The description element of the retail of LPG indicated the following non-conforming aspect: “[O]nly Mexican nationals and Mexican enterprises with a foreigners' exclusion clause may engage in the distribution, transportation, storage, or sale of liquified petroleum gas and the installation of fixed deposits.” Meanwhile, the retail Gasoline and Diesel, which is qualified by a liberalization commitment, is described as follows: “[O]nly Mexican nationals and Mexican enterprises with a foreigners' exclusion clause may acquire, establish or operate retail outlets engaged in the sale or distribution of gasoline, diesel, lubricants, oils or additives.”

Before FIA’s amendment, article 6(II) FIA, in essence, provided that Mexican companies could only conduct the distribution, transportation, and sale of LPG and the retail of gasoline products.\textsuperscript{101} The energy overhaul lifted the restrictions on foreign investment in midstream and downstream activities related to LPG and gasoline by eliminating section (II) of article 6 FIA.\textsuperscript{102} The non-conforming measures are in full conformity with article 1102 NAFTA and, therefore, the energy overhaul has eliminated the legal effects of these two NAFTA reservations, since Mexico is prevented from restoring or increasing the non-conformity level of the measure in accordance with article 1108(1)(c) NAFTA. Hence, investors of a NAFTA party and their investments in the midstream and downstream activities related to LPG and gasoline are fully covered by NAFTA’s investment chapter and enjoy all absolute and relative rights.

F. **ANNEX II NAFTA**

Mexico inscribed in its schedule to Annex II a reservation applicable to the oil sector. However, it is taken with respect to provisions of the cross-border trade in services chapter. This NAFTA reservation is not affected by the recent energy overhaul since this schedule is not subject to the ratchet clause as it deals exclusively with future measures. Therefore, Mexico may eventually adopt more stringent measures that affect cross-border trade in services.

\textsuperscript{101} Article 6(II), FIA (as amended in D.O.F. 24 December 1996)

\textsuperscript{102} Article 6(II), FIA (as amended in D.O.F. 11 August 2014)
G. ANNEX III AND ANNEX 602.3 NAFTA

Annex III NAFTA is unique as Mexico was the only party to submit a schedule of this kind. It is argued that the exact nature of these NAFTA reservations is not that clear.\(^{103}\) Mexico’s schedule is divided into three sections, Section A (Activities Reserved to the Mexican State), Section B (Deregulation of Activities Reserved to the State), and Section C (Activities Formerly Reserved to the Mexican State), the first two being relevant for the present analysis. In Section A, Mexico listed 11 economic activities, the first one being applicable to the oil sector, which is as follows:

Mexico reserves the right to perform exclusively, and to refuse to permit the establishment of investments in, the following activities:
1. Petroleum, Other Hydrocarbons and Basic Petrochemicals
   (a) Description of activities
      (i) exploration and exploitation of crude oil and natural gas; refining or processing of crude oil and natural gas; and production of artificial gas, basic petrochemicals and their feedstocks and pipelines; and
      (ii) foreign trade; transportation, storage and distribution up to and including first hand sales of the following goods: crude oil; natural and artificial gas; goods covered by Chapter Six (Energy and Basic Petrochemicals) obtained from the refining or processing of crude oil and natural gas; and basic petrochemicals.
   (b) Measures:
      Constitución Política de los Estados Unidos Mexicanos, Artículos 25, 27 y 28
      Ley Reglamentaria del Artículo 27 Constitucional en el Ramo del Petróleo
      Ley Orgánica de Petróleos Mexicanos y Organismos Subsidiarios
      [...] 
          The measures referred to are provided for transparency purposes and include any subordinate measure adopted or maintained under the authority of and consistent with such measures.

In turn, Section B is divided into two paragraphs, and it provides the following:

1. The activities set out in Section A are reserved to the Mexican State, and private equity investment is prohibited under Mexican Law. Where Mexico allows private investment to participate in such activities through service contracts, concessions, lending arrangements or any other type of contractual arrangement, such participation shall not be construed to affect the State’s reservation of those activities.
2. If Mexican law is amended to allow private equity investment in an activity set out in Section A, Mexico may impose restrictions on foreign investment participation notwithstanding Article 1102, and describe them in Annex I. Mexico may also impose derogations from Article 1102 on foreign equity investment participation when selling an asset or ownership interest in an enterprise engaged in activities set out in Section A, and describe them in Annex I.

As noted, Mexico reserved the right to ‘perform exclusively economic activities’ and ‘to refuse to permit the establishment of investments’ in upstream and midstream activities in the oil sector and it inscribed as

\(^{103}\) UNCTAD, Admission and Establishment (n 27) 26
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non-conforming measures articles 25, 27, and 28 of the Constitution and other two laws governing the oil sector. Mexico’s NAFTA reservations are not affected if there is private investment through service contracts, concessions or “other type of contractual agreements” in accordance with Section B(1). Moreover, in Section B(2) Mexico introduced the possibility of imposing restrictions on foreign investment in the event that “private equity investment” is allowed.

As noted above, this schedule is not governed by interpretative rules. The ICJ’s jurisprudence on the interpretation of reservations serves as a subsidiary means for determining the applicable rules for interpreting a NAFTA reservation due to their eclectic nature. Accordingly, a reservation should not be interpreted restrictively, rather “reasonably” and “in a manner compatible with the effect sought”, taking into account not only the text, context and object of the treaty, but also different elements that reflect the intention of the reserving State. Additional elements other than the text of Annex III, such as Annex 602.3 NAFTA, Mexico’s previous domestic law and the purpose of the reservation, allow one to ascertain Mexico’s intention.

Though this paper has proven that Mexican Law has been amended, the key to determine whether the energy overhaul has affected the legal status of Mexico’s NAFTA reservations lies in the concept of “private equity investment” found in Section B(2). This concept is neither defined under NAFTA nor Mexico’s domestic law, and thus one must unravel the meaning of Mexico’s NAFTA reservation to determine if the amendments to Mexican Law allow private equity investment. The term “equity investment” is qualified by “private”, an adjective that means ”relating or belonging to an individual, as opposed to the public or the government[.]”. In turn, equity, a synonym of capital, means, inter alia, “money or assets invested, or available for investment in a business[.],” while investment means ”the commitment of funds or other assets with the purpose to receive a profit.” The definitions of the term “investment” under article 1139 NAFTA provide immediate context, and one may also argue that the term “enterprise” or “equity security of an enterprise” are suitable meanings for the case at hand. In this sense, private equity investment refers to capital or assets invested in an enterprise that belongs to an individual or an enterprise that is not from the government. Following ICJ’s rules on the interpretation of reservations, the circumstances of the formulation

104 Fisheries jurisdiction (Spain v. Canada) Jurisdiction of the Court, Judgement, ICJ Reports 1998 [44]-[52] (Fisheries jurisdiction (Spain v. Canada)); ILC (n 30) 467-472; Van Damme (n 55) 105
106 ibid
of Mexico’s NAFTA reservation indeed confirms such interpretation, because the Mexican Constitution, FIA’s predecessor and FIA itself prohibited private investors, e.g. privately held enterprises, to participate in the oil sector as it was exclusively reserved to the State.

The amendments to Mexico’s domestic legal framework amount to allow private equity investment in the oil related activities listed in Mexico’s schedule to Annex III. As noted above, the constitution previously provided that the petroleum listed activities were to be carried out exclusively by the State.\(^{107}\) Although the exploration and extraction of oil and hydrocarbons continues to be considered the only strategic activity of the oil sector, the amendments to article 27 of the Constitution and the Hydrocarbon Act allow privately held enterprises to participate, through contracts, in the exploration and extraction of oil and hydrocarbons. Further, as a result of the constitutional amendment, the treatment and refinement of crude oil, basic petrochemistry, international trade, transportation, storage and distribution of oil goods are no longer activities that must be exclusively performed by the State and, pursuant the Hydrocarbon Act, privately held enterprises may engage in the aforementioned activities provided they obtain a permit.\(^{108}\) Therefore, Mexico’s NAFTA reservations concerning investments in the oil sector introduced in its schedule to Annex III NAFTA were affected by the energy overhaul, because Mexican Law was amended as to allow private equity investment to conduct activities that were expressly reserved to the State.

It is also important to address Section B(1) of Annex III, since it may still be argued that Mexico’s NAFTA reservations are not affected by the energy overhaul. Pursuant section B(1), Mexico’s NAFTA reservation shall not be considered affected if investors participate through “[...]contracts, concessions, lending arrangements or any other type of contractual arrangement[...]”.\(^{109}\) Consequently, one may argue that a contract for the exploration and extraction of hydrocarbons falls under the category of “any other type of contractual arrangement” and, therefore, the participation of private investment shall not be construed so as to affect Mexico’s NAFTA reservation in accordance with Section B(1). Such interpretation, however, is not reasonable because it does not take into account the entire structure of Mexico’s schedule and the circumstances of its formulation. This is so because, according to Section A, Mexico reserved such activities to perform them exclusively and to refuse the establishment of investments, and, pursuant the first sentence of Section B(1), “[...]private equity investment is prohibited under Mexican Law”. If private equity

\(^{107}\) see n 99

\(^{108}\) Article 48, Hydrocarbons Act (n 81)

\(^{109}\) NAFTA (n 1) Mexico’s schedule to Annex III Section B(2)
investment is no longer prohibited in the reserved activities due to amendments to the constitutional and legal framework, Mexico is no longer performing exclusively such activities. In this sense, the second sentence of B(1) should not be given undue weight so as to be a “catch-it-all” clause and impeding Section B(2) to purport its effects when private equity investment has indeed been allowed.

Although the energy overhaul affected Mexico’s NAFTA reservation introduced in its schedule to Annex III, Mexico’s NAFTA reservations, in fact, are not eliminated and are still producing legal effects because Section B(2) allows Mexico to impose derogations on foreign investment regarding national treatment. However, it is not clear whether Section B(2) covers Mexico’s right to impose performance requirements that are prohibited under NAFTA’s investment chapter. One may even construe that the only type of restrictions that Mexico may impose are those related to the national treatment obligation, since there is no express reference to article 1106 NAFTA. In order to resolve this issue, the ICJ’s jurisprudence on the interpretation of reservations guides one to take into account NAFTA’s whole structure as well as exogenous elements. In turn, one must refer to Annex 602.3(1) NAFTA, whereby Mexico introduced a hierarchy rule in case of an inconsistency between such paragraph and another NAFTA provision, like Section B(2) of Mexico’s schedule to Annex III. The relevant part of 602.3(1) NAFTA states: “1. The Mexican State reserves to itself the following strategic activities, including investment in such activities and the provision of services in such activities: [...].” The activities listed in Annex 602.3(1) are identical to those in Mexico’s schedule to Annex III.

Annex 602.3(1) has a broad scope, particularly, due to the terms used. Notably, Mexico uses the term “including”, which has been interpreted broadly in other contexts and its ordinary meaning is, inter alia, “containing a part of a whole.” In the case at hand, the word “including” is not to be construed as an exhaustive list, a reading that also takes into account the circumstances in which the reservation was formulated. This is so, because Mexico’s previous oil regime indeed reflects the intention of preserving its regulatory and economic control of its oil and oil-related activities. Annex 602.3(4), in fact, further supports such reading by allowing Mexico to impose domestic content requirements in the service contracts, as it

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10 Ibid
11 ibid, Annex 602.3(1) (emphasis added)
12 The relevant text of Annex 602.3(1) is available supra
provides that “each Party shall allow its state enterprises to negotiate performance clauses in their service contracts.” It follows that Mexico’s reservation in Annex 602.3(1) NAFTA extends beyond “investment” and “services”, as it also covers, inter alia, the right to regulate foreign investment and economic activities. In light of the above, one may conclude that Mexico reserved its right to impose performance requirements in accordance with Annex 602.3(1).

The prima facie inconsistencies of Mexico’s domestic legal framework concerning upstream and midstream activities in the oil sector are covered by Mexico's NAFTA reservations introduced in its schedules to Annex III NAFTA. However, such inconsistencies “must” or “have to” be described in Mexico’s schedule to Annex I in accordance with Section B(2). The fact that Mexico has not yet described the derogations poses an interesting debate on whether Mexico’s NAFTA reservations inscribed in its schedule to Annex III are still producing legal effects.

Under these circumstances one must again refer to international jurisprudence to solve this question. In the context of reservations, the ICJ has recognized that an interpreter has to read a reservation pursuant the purpose of the reserving author.114 In the context of treaty interpretation, the Appellate Body of the World Trade Organization recognized that, in accordance with the "general rule of interpretation" embodied in VCLT, an interpretation “must give meaning and effect to all the terms of a treaty. An interpreter is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility.”115 Moreover, when faced with article XX GATT, the general exception clause, the Appellate Body highlighted that it serves an important function of maintaining a balance between the right of a Member invoking an exception, which is not to be rendered illusory, and the substantive rights of other Members; and thus the task of interpreting and applying article XX, in particular the chapeau, is “locating and marking out a line of equilibrium between” both rights, whereby they are not canceled out and thereby disrupting the balance.116

114 Fisheries jurisdiction (Spain v. Canada) [n 104] [52]
The Energy Overhaul’s Effects on Mexico’s NAFTA

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Bearing in mind these interpretative guidelines and the manner in which it has been applied, if one considers that Mexico’s reservations are not producing effect, one would deprive not only Mexico’s customary reserved right but also article 1108(1)(a) and (c) NAFTA of all meaning and effects, if Mexico fails, for any reason, to describe the restrictions in Annex I. Likewise, the same effect appears on Section B(2) of Annex III, if one considers that Mexico’s NAFTA reservation continue to purport their effect. However, and similar to function of article XX GATT, it is amply recognized that the purpose of the reservations system under NAFTA is to create a balance between a Party’s liberalization commitments and preserving certain policy flexibility in accordance with their national interests; this is recognized by the majority and the dissenting arbitrator in Mobile & Murphy.\textsuperscript{117} Hence, one should prefer the reading whereby Mexico is allowed to maintain its non-conforming measures, as amended or renewed, since this interpretation maintains such balance, is consistent with the purpose of Mexico’s NAFTA reservation, NAFTA’s special object and purpose applicable to the energy, which recognizes that liberalization of the energy sector is a gradual process, as well as NAFTA’s entire structure, in particular, article 1108(1)(c).

In sum, Mexico’s NAFTA reservations in its schedule to Annex III related to the oil sector are still producing legal effects. Therefore, Mexico may continue to accord less favorable treatment to foreign investors than that accorded to PEMEX in the acquisition and establishment of investments in upstream and midstream activities listed in its schedule to Annex III. Mexico may also continue to impose the three prohibited performance requirements discussed above, but only to the upstream and midstream activities that were previously reserved to the State. Finally, Mexico’s right to restrict foreign investment is limited to the actual level of inconformity established in the Hydrocarbon Act, FIA, and its domestic legal framework. Hence, Mexico cannot increase or restore the non-conformity level pursuant article 1108(1)(c) NAFTA.

IV. CONCLUSION

The full liberalization model is highly adaptive to changes in investment policies as it covers automatically new sectors and protects investments without renegotiating an agreement. Given that the full liberalization model is increasingly embraced in recent international investment agreements,\textsuperscript{118} such as in the investment chapter of the recently signed Transpacific Partnership Agreement (“TPP”), reservations play a fundamental

\textsuperscript{117} Mobile & Murphy (n 43), [340]; Dissenting Opinion—Mobil & Murphy (n 45), [5]

\textsuperscript{118} UNCTAD, World Investment Report 2015:Reforming International Investment Governance (United Nations, 2015)
role for their conclusion by allowing States to carve out economic sectors that are considered sensitive. In investor-state disputes, Panels and parties have failed to examine in depth the underlying legal nature of a reservation to an IIA because of the existing dichotomy between treaty and customary international law. Hence, reservations to an IIA with a full liberalization model should be approached differently; different interpretative guidelines are required to prevent outcomes that undermine the intention of the reserving state, such as in Mobile & Murphy.

This article proved that not all of Mexico’s NAFTA reservations concerning investments in the oil sector were eliminated by the energy overhaul. In fact, Mexico is not obliged to achieve full conformity with the substantive obligations of NAFTA’s investment chapter. As a result of the energy overhaul, Mexico has established a new regulatory ceiling concerning its ability to regulate (or restrict) foreign investment and economic activities in the oil sector due to NAFTA’s ratchet clause. On the one hand, the legal effects of Mexico’s NAFTA reservations introduced in its schedule to Annex I were, to a great extent, eliminated by the energy overhaul since most of the reserved measures achieved full conformity with NAFTA’s national treatment obligations. In this regard, it is important to note that Mexico is probably not complying with article 1106 NAFTA, if the requirement to prefer goods and services of national origin are introduced in the permits granted to investors to engage in midstream and downstream activities relating to LGP and gasoline. On the other hand, Mexico may accord, under certain circumstances, better treatment to PEMEX and impose performance requirements on investments in upstream and midstream activities under NAFTA pursuant to its schedule to Annex III.

Needless to say, NAFTA does not exist in isolation of other treaties. Though this article did not address the issue of the fragmentation of international law, it is relevant to mention certain issues that arise from the energy overhaul. Though justified by Mexico’s NAFTA reservations for certain activities, the domestic content and the obligation to prefer goods of national origin requirements introduced in the energy overhaul are contrary to the laws of the World Trade Organization (“WTO”), namely the General Agreement on Tariffs and Trade 1994 and the Agreement on Trade-Related Investment Measures. Investors of a NAFTA party may therefore challenge the aforementioned requirements because they are contrary to Mexico’s WTO obligations. However, success is not guaranteed as a transitory article of the Constitution requires the establishment of the performance requirements. If a dispute is brought to an international fora, in particular
NAFTA’s dispute settlement, one wonders how will WTO law interact with Mexico’s NAFTA reservations.119

Energy-investment disputes are common in the international fora, accounting for 37% of the cases in the International Center for Settlement of Investment Disputes as of 2012.120 As a result of the energy overhaul, private equity investments is now allowed, and, therefore, Mexico will no longer be able to bar investors from the investor-state dispute settlement mechanism because Mexico no longer refuses the establishment of private investments and performs exclusively the said activities.121 Furthermore, if TPP enters into force, investors of Canada and the United States of America may select their forum of choice, either NAFTA’s and TPP’s investor-state dispute settlement mechanism, as NAFTA will coexist with TPP.122

Investors of a NAFTA party and their investments in the Mexican oil sector currently enjoy to a great extent most of the relative and absolute rights granted by NAFTA’s investment chapter. It follows that Mexico must not arbitrarily or unreasonably frustrate investor’s expectations, discriminate at the post-establishment phase or expropriate property and contractual rights, and comply with the rest of its NAFTA investment obligations, namely providing full protection and security, permitting free transfers of capital as well as to freely control an investment.

Mexico has once again opened the door to foreign investment in the oil sector under NAFTA’s investment chapter, however, the door is not completely opened due to Mexico’s NAFTA reservations. Now the question is whether the Mexican State is prepared to comply and fulfill their international obligations in one of the most sensitive and complex economic sectors of the country.

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121 cf. Rios and Poretti (n 6) 353