



THE RULE OF LAW AND MEXICO'S ENERGY REFORM

Prologue: Energy, The Law, and “The Mexican Way”

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About the Study: The Rule of Law and Mexico’s Energy Reform/Estado de Derecho y Reforma Energética en México

The 2013 changes to the constitutional framework and the summer 2014 enabling legislation in Mexico’s energy industry represent a thorough break with the prevailing national narrative as well as the political and legal traditions of twentieth century Mexico. Mexico is about to embark on an unprecedented opening of its energy sector in the midst of important unknown factors, as well as a fiercely competitive and expanding international energy market. Mexico is one of the last developing countries to open its energy sector to foreign investment, and although there are important lessons that can be learned from other countries’ experiences, this does not imply that the opening will be necessarily as successful as the government promises or that the implementation of the new laws will go smoothly. Almost certainly, after the enabling legislation goes into effect, important questions of law will emerge during the implementation, and unavoidably, refinements to the legislation will have to take place.

The book “Estado de Derecho y Reforma Energética en México,” published in México by Tirant lo Blanch and written in Spanish, is the culmination of a major research effort to examine rule of law issues arising under the energy reform in Mexico by drawing on scholars and experts from American and Mexican institutions in order to bring attention to the different component parts of the new Mexican energy sector from a legal standpoint.

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Foreign investors in Mexico should understand the particularities of the country’s legal and political culture. While important structural reforms have been made over the past few years, not least in the energy sector, the legal and political context of the reforms is very different from that of the United States and other democratic countries. The concept of the law itself is understood differently and the ways and criteria under which decisions are made bear no resemblance to similar considerations in the United States. This difference should not deter investors from exploring opportunities in Mexico’s energy sector, but it should make them aware that the way decisions are made vis-à-vis the law, and adherence to it, are clearly distinct.

Energy has long been a critical and highly political sector in Mexico's economy; it has been under strict governmental management since 1938. As a result, the sector is less developed than in countries with similar income levels. Moreover, Mexico’s energy sector evolved within a political context that largely disregarded basic market principles, including open competition, that characterize most of the world energy economy. As a state-owned monopoly, PEMEX dealt with private companies as clients, suppliers, and contractors—all under apparently normal contractual relationships, but that in reality were deeply influenced by political forces and interests. One result of this exceptional situation was, of course, a relatively low number of contractual disputes between PEMEX and its contractual partners, mostly because of the monopsony that characterized the Mexican energy markets.

All of this changed in 2013 and 2014 when Mexico amended its constitution and passed enabling legislation overhauling its energy sector to allow private and foreign investment. This opened up a multitude of opportunities and mechanisms for private parties to invest, participate in, and run independent energy operations in the country. The new legal framework not only liberalized the sector but also created a new reality on the ground, one in which interactions among the players, old and new, will require new rules, new dispute settlement procedures, and new expertise in legal matters. Importantly, it also redefined Mexico’s prevailing culture and legal norms. Many potential players in the energy sector are experienced in these battles—as they have dealt with similar state-controlled economies elsewhere—but this is not true for Mexico and Mexicans. In Mexico, the law itself has never been a priority, nor do the players abide by it. Political, rather than legal, criteria has ruled over energy (and, to a large extent, over Mexico in general). The law and the constitution could be considered more of a series of aspirations than of strictly adhered-to rules.

Foreign companies and potential national and international investors willing to venture into Mexico’s energy sector need to be aware of the legal and political circumstances under which they would be operating. As the chapters in this book explain, the legal and political complexity inherent in the new constitutional framework will sooner or later have to be addressed. Hence, this prologue aims to provide a contextual background on the rule of law in Mexico as a general concept, one that should guide the reading of this book.

The Rule of Law

This is a book written mostly by lawyers on a topic that has become critical for most nations and most certainly for Mexico—the rule of law. The rule of law is indeed a catch phrase but it also entails a conception of relationships among parties in a transaction. In addition it constitutes a fundamental difference in the way a society behaves and interacts. Thus, there are enormous differences in the way developed and developing countries regard the law. Although, in truth, there is little agreement on what the concept means, it is nevertheless easy to assume that one’s view is universal. Lawyers give it one meaning, for instance, while economists have developed more far-reaching definitions. Most important, while lawyers tend to see the normative side of the world first, other social scientists tend to see incentives and disincentives in rules and procedures.

This prologue draws attention to this important debate and provides a quick reflection to guide the reader of this book to the complexity of the rule of law in Mexico. Mexicans use the term “Estado de derecho”—rule of law—generously, but its meaning varies widely depending on who employs it. For some it is merely a political label; for others it is a way to justify their actions; for still others, it is merely a rhetorical construct. In a political system without checks and balances, the president could change the rules on a whim, making a mockery of the very concept of the rule of law. Similarly, the weakness of Mexico’s judicial system underlies the inability of the state itself to both adhere to the law and compel others to do so. It is important to understand that, despite the radical redefinition of the legal framework of the energy sector, the basic concept of the law has changed little. Although a major reform of the judiciary is underway, there is little reason to expect major changes anytime soon. Although the presidency is considerably less powerful than it has been in the past, the executive branch still has enough power to change the rules for its convenience, or to use a complex and often contradictory legal apparatus to flout agreements and contracts, facilitating or obstructing their execution. That is the main challenge foreign investors will have to live with should they decide to participate in Mexico’s newly overhauled energy markets.

Nonetheless, Mexican political leaders understand the implications of the absence of checks and balances, and the need of foreign investors to have clear and recognized rules and recourses in case of disputes. In fact, the whole point of negotiating NAFTA in the 1980s was to find a way to guarantee foreign investors that the rules would not change in a capricious way.

NAFTA represented a commitment by Mexico not to expropriate companies without cause, not to favor some companies over others, and not to issue arbitrary regulations and rulings. In a way, NAFTA was a way to import the rule of law from the U.S. for investment purposes. Over the past twenty years, NAFTA has served its objective grandly. In fact, NAFTA is still Mexico’s main engine of growth and the source of much of the certainty in rules and regulations for foreign investors in the Mexican economy.

When NAFTA was negotiated, however, the energy sector was left out of the agreement due to the constitutional restrictions at that time. With these restrictions now removed, the provisions in NAFTA’s Chapter 11 that guarantee the rights of foreign investors should presumably apply to energy-related investments as well. Hence, a key question now is how well these provisions will be complied with in the still highly politicized energy sector, where high stakes games play an inextricable role and are important to relevant parties, including the domestic actors that have long benefitted from the status quo.

As Mexico implements its new energy legislation, it will have to find a way to accomplish what NAFTA has done with much of the economy: guarantee clarity and observance of agreements and contracts. If one looks at the way the government has sharpened and adjusted the rules for the successive rounds of bids in oil and gas, it is obvious that there is a clear understanding of the needs of the industry and a willingness to meet them. The question is whether NAFTA will become the relevant mechanism to settle disputes or if alternative mechanisms to achieve this same clarity and adherence to the law will be created.

The need for this is obvious. One comparative index¹ that evaluates the degree to which the rule of law is respected in different countries employs eight indicators: limits to governmental authority, absence of corruption, governmental transparency, fundamental citizen rights, order and security, the ability to enforce regulation, civil justice and criminal justice. The index ranks Mexico 79th of the 99 countries surveyed. Taken together, the indicators attempt to measure only one thing: Does the government (including the legislative and the judicial branches) work to protect the rights of individuals (including investors) or not? The country’s low score would not surprise Mexicans—hence the need to employ trade agreements that help “import” the rule of law and the guarantees they offer, such as the international arbitration mechanisms established to mediate contractual disputes.

Final Considerations

The principle behind the rule of law is that governmental authority is legitimately exercised only in accordance with rules that are written, publicly disclosed, and enforced through well-known, pre-established procedures. The rule of law intends to be a safeguard against arbitrary action by the government, and is no mere technicality. This is the essence of the rule of law. Poor governmental conduct pays a very high price in the form of failure of governance and, ultimately, economic development.

Asserting the rule of the law implies a commitment to a distinct social, political, and legal order. In principle, it entails a disposition to accept the law as the norm and the mechanism of interaction among persons, organizations, and the government on all matters. It implies

¹ *Rule of Law Index 2014* (The World Justice Project: Washington, D.C.), http://worldjusticeproject.org/sites/default/files/files/wjp_rule_of_law_index_2014_report.pdf.

that the government (including police, prosecutors, etc.) is required to be scrupulously transparent in all of its actions.

As the energy reform moves forward, Mexico’s capacity to deal with conflict and contractual disputes will be tested. In the absence, at least as of this writing, of a political context that fully guarantees the principle of the rule of law, the hope is that the commitment shown in the process of passing the reforms will also carry through to the political context in which the energy sector operates.