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Law and Arbitration of Oil and Gas Disputes in Brazil and Mexico by O.F. Cabrera Colorado and E. Silva da Silva

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Law and Arbitration of Oil and Gas Disputes in Brazil and Mexico

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Abstract

One of the paradoxes of oil and gas disputes is the arbitrability of contracts in which a party is an international petroleum company and the other a State entity, especially if the entity is based at a Latin American country. Due to the fact that such disputes involve political decisions as well as risky, complex and sophisticated investments, arbitration and alternative mechanisms of dispute resolution are preferred methods for the settlement of disputes.

The decline in the production of Petróleos Mexicanos (PEMEX) as well as the discovery of the reserves of *"pre-salt"* in Brazil presented new challenges which obliged Mexican and Brazilian Governments to enact new regulations for oil and gas. This article examines the regulatory framework governing oil and gas industry in Brazil and Mexico with special emphasis on the different ways of accepting and managing the risks of dispute resolution. In addition, it provides a general view of the entities involved in the industry.

Whilst the Mexican laws have accepted arbitration and alternative means of dispute resolution since 1990s; the current Brazilian regulations regarding *pre-salt* areas harmed the use of these mechanisms. The Brazilian Federal Public Attorney recommended, in certain cases, submitting to arbitration only if arbitration procedures are conducted by a committee of the Brazilian Government. Similar provisions may be found in the Mexican Gas Regulation but not in the Mexican Oil Laws which provide a wide arbitration oriented regulation.

These frameworks create different risks for investors that should be carefully examined before carrying out any exploration or production of petroleum.

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1. Legal Framework of Oil and Gas

a. Petrobras, a company of superlatives

Petrobras is a company of superlatives. It is one of the major oil companies in the world and the largest Brazilian company. Not only it is the main company of the Stock Market of Sao Paulo, but also it is a major sponsorship of several activities involving research, sports and culture.

Its origin derives from a massive mobilization that occurred in Brazil in the 50s, when Brazilians were discussing the exploitation of domestic oil. The campaign "Oil is ours" swept across the country and moved to many sectors of society, determining the creation of a private company, publicly traded and state controlled, to explore the black gold of Brazil.[1] The literature of the time and the analysis of those facts show that the economic issues related to oil have always assumed, in Brazil, a strong political and social connotation.[2]

In order to understand the current context of Petrobras, it is necessary to recover some data from the Brazilian legal experience, not always understood by the external points of view.[3]

In the fifties, strong nationalist movements led to the establishment of the Federal monopoly of exploration and prospecting of oil and Petrobras became the company responsible for such activities.[4] This model was established by the Constitution enacted in 1988, the first after a long period of dictatorial rule imposed by the Brazilian militia.[5] The Constitution stated the monopoly of the Union,[6] for the exploration and prospecting of oil, forbidding concessions of oil

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[1] See MIRANDA, M. A. T. O petróleo é nosso: a luta contra o entreguismo pelo monopólio estatal. Petrópolis: Vozes, 1983.

[2] ALMEIDA, Paulo Roberto. "Monteiro Lobato e a emergência da política no petróleo no Brasil", capítulo do livro Gás natural: energia limpa, para um futuro sustentável, organizado por BARROS FILHO, Omar. Porto Alegre: Laser Press Comunicações, 2008. Available at http://www.pralmeida.org/05DocsPRA/1925MonteiroLobatoPetroleoBr.pdf

[3] In 1955 the Times criticized the Brazilian option for nationalism, saying it would remain frustrated exploration of possible oil reserves in Brazil by giving in to resistance to foreign exploitation. Available at http://www.time.com/time/magazine/article/0,9171,891443,00.html

[4] KANDRAS, Ester. *Da definição da política petrolífera brasileira 1953-1969.* Tese de Doutorado na Universidade de São Paulo, 1989.

[5] COUTO, Cláudio Gonçalves e ARANTES, Rogério. "*Constitution, governement and democracy in Brasil,"* Revista Brasileira de Ciências Sociais, Available at http://cepesp.fgv.br/node/200.

[6] The Federative Republic of Brazil is formed by the indissoluble union of the States and Municipalities and of the Federal District (According article 1 of the Constitution of Brazil). The Union is the federal entity formed by the meeting of the component parts, a legal entity of public law, independent from the

and any other private participation in the exploitation of hydrocarbons and natural gas. In addition, it gave Petrobras the status of state entity.

The political, cultural and economic landscape changed in Brazil. After the military regime (1964-1985) and a transitional government (1985-1989), the first elected president (and further prevented) recognized the need to open the Brazilian economy. In fact, the government of President Fernando Henrique Cardoso implemented a series of constitutional changes in order to refresh and open the Brazilian economy.

This new framework allowed, in 1995, the adoption of Constitutional Amendment 09. Such Amendment stipulated the monopoly of the Union, over the exploration and production of oil, natural gas and hydrocarbon fluids. However, a special law allowed the participation of the State and private companies to perform the above activities. The wording of article 177 of the Constitution was amended as follows:

Original wording in 1988:

> The monopolies of the Union are:
>
> I - Prospecting and exploitation of petroleum and natural gas and other hydrocarbon fluids.
>
> Paragraph 1 - The monopoly in that article includes the risks and outcomes from the activities mentioned therein, the Union is not allowed to transfer or grant any type of contribution, in kind or in value in the exploration of petroleum or natural gas, except as provided in Article 20, paragraph 1.

Wording after the Amendment No. 09/95:

> The monopolies of the Union are:
>
> I - Prospecting and extraction of petroleum and natural gas and other hydrocarbon fluids.
>
> Paragraph 1 - The Union may contract with state or private companies in order to carry out the activities set forth in sections I to IV of this article, in the terms provided by law.

Two years after the promulgation of the constitutional amendment, Law No. 9478 was published. Said law *"Treats the national energy policy, the activities related to the oil monopoly, establishing the National Energy Policy Council and the National Petroleum Agency and other measure"*

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federal units that must exercise the prerogatives of state sovereignty of Brazil. Brazil is represented abroad by the Union. The President is at the same time, Head of the Brazilian State, Head of the federal government (Government of the Union) and the Chief Executive (articles. 2 and 76 of Constitucion). The legal entity of international law is the federal state (article 21, I-IV of the Brazilian Constitution).

and states that: "*the exploration and production shall be performed through concession contracts entered into by and between companies incorporated under the laws of Brazil, with registered office and administration in the country*"(Article 5 with 23 of Law 9.478/97). Article 26 is even more explicit:

> The concession implies for the concessionaire an obligation to exploit, at its own risk and, if successful, produce oil or natural gas in a given block, giving it ownership of these resources once produced, with the corresponding payment of taxes and related legal or contractual participations.

A new production system, therefore, was established. Petrobras lost its exclusivity as an agent of the Brazilian State for oil exploitation.[7] Therefore, the State is authorized, through bidding procedures, to enter into contracts with public or private companies that have technical and legal conditions for such activities. The constitutional amendment was considered by some political and legal sectors as nefarious, because it could weak the Brazilian government and "privatizes" the economy. Therefore, the unconstitutionality of the amendment was claimed before the Brazilian Constitutional Court on the basis of various principles and values established in the Constitution of 1988.

The Brazilian Supreme Court resolved on the new provisions and its consequences. In Direct Action of Unconstitutionality (ADI) No 3273, the Supreme Court clearly decided to maintain the monopoly of the Union and the domain of these resources.[8] The Supreme Court resolved that it is possible to enter into an exploration and production contract with any public or private company, prior bidding, through "concession contracts" entered into by and between companies incorporated under the laws of Brazil with registered office and administration in the country.[9]

The decision of the Brazilian Supreme Court was not unanimous and revealed the political controversy that surrounded the constitutional text. The fact that the Direct Action of Unconstitutionality was submitted by a State Governor and supported by a series of *amicus curiae* briefs denoted the high level of debate in Brazil. Even the original *rapporteur* of the case - Judge Carlos Britto - voted for the unconstitutionality of the new provisions, which were accompanied by the votes of Judge Marco Aurelio Mello and Judge Joaquim Barbosa. The other Judges disagreed and resolved to declare the constitutionality of the law for oil exploration.

The vote of the designated *rapporteur* for the ruling - Eros Grau - begins by distinguishing

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[7] COSTA, Antonio Rufino e LOPES, Fernando Dias. Participation of Foreign Companies and Consortia in Brazilian Oil and Gas Bidding. Revista de Administração Contemporânea, volume 14, n. 5. Also available at *Directory of Open Acess Journal Free*.

[8] Ação Direta de Inconstitucionalidade n. 3273-8, Judge Eros Grau.

[9] Law Nº 9.478, dated on 6 August 1997, Articles 5 and 23.

between *activity* of the Union and *property* of the Union. From the text of Amendment 09/97, the concept of economic activity waives the ownership of production. The ruling, therefore, gave meaning to the new amendment; oil was still owned by the Union, but no more the economic activity of extraction. [10]

This important and crucial distinction clarifies the rules on the constitutionality of oil exploration in Brazil: the domain of the extraction's result of petroleum, natural gas and other hydrocarbon fluids may be assigned to third parties by the Union, without any offense to reserve monopoly. [11]

We can infer from the above that Petrobras is no longer a company for the development of public service and is not an agency of the Union; therefore, it needs to follow the legal status of other private companies. According to the ruling, Petrobras acts under a competition regime with other private companies. [12]

The new system - still in force in most areas explored in Brazil - involves bidding procedures and grants to those companies that assume at their risk the obligation to operate oil fields, the ownership of resources after payment of legal participation to the Brazilian State.

The state of art in that historical moment recommended allowing the exploitation of the natural reserves in Brazil to any company. The blocks to be explored were of low profitability and high risk; moreover, Brazil was an oil importing country and there was a shortage of resources for investment. Additionally, Petrobras had few financial resources, there was a difficulty in attracting investment and the price of a barrel of oil orbited around USD$20.[13]

Petrobras is a mixed capital company linked to the Ministry of Mines and Energy. The objectives of the company are the exploration, exploitation, refining, processing, trade and transport of oil from wells, shale and other rocks, its derivatives, natural gas and other hydrocarbon fluids and any other related or similar activities, as defined by law.[14] Since 1997, Petrobras is a company that, under equal conditions, competes with others for the right to obtain a concession contract; however, it was characterized to be a company of superlatives.

The discovery of reserves known as *pre-salt* will increase the dimensions and challenges of this mega company. The fields already confirmed to be part of the largest oil basins in the world. With the *pre-salt* discoveries, Brazil is aligned with the world's largest producers of oil, next to

[10] ADI nº 3.373, Judge Ministro Eros Grau, 16 March 2005.
[11] ADI nº 3.373, Judge Eros Grau, 16 March 2005.
[12] ADI nº 3.373, Judge Eros Grau, 16 March 2005.
[13] See ZACOUR, Claudia. "Modelos contratuais e o modelo proposto para a indústria do petróleo no Brasil", abril de 2010, apresentado no Seminário "Pré-sal na USP", availabel at www.presalnausp.com.br
[14] Lei nº 9.478, 6 August 1997.

Saudi Arabia, Iran, Iraq and Kuwait.[15] While these areas have trends of depletion and exhaustion, the new discoveries in other regions of the globe, take a long time for future exploration.[16] The Tupi field, discovered in 2007, initiated production in 2010.

In building a model framework for the discipline of holding these reserves, political and economic factors had great influence. Laws 12.276/10, 12.351/10 and 12.304/10 are the result of months and dense debate in the Congress and, potentially, will flow into the Supreme Court.[17] In this moment of prominence in the economic scenario, there is an increasing legalization of politics and even economics. The Supreme Court has been called upon to resolve issues involving policy (such as party loyalty and the conditions of eligibility as public officer) and economy (issues involving the energy matrix).[18]

b. Mexico

i. Legal Framework of Oil and Gas

The Mexican Nation owns all the oil and all solid, liquid and gaseous hydrocarbons. The Nation's domain shall not be transferred to others and will be permanent. Neither concession nor contract shall be granted with regard to oil and solid, liquid, gaseous or radioactive hydrocarbons and the Mexican Nation shall carry out the exploitation of the above-mentioned materials according to Statutory Law.[19] All domestic hydrocarbons resources and basic petrochemicals are deemed to be strategic activities which are exclusively reserved to the State.[20]

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[15] ZACOUR, Claudia. op. cit.

[16] For instance, the discovery of oil in Kashagan will start production in 2013.

[17] See Ação Direta de Inconstitucionalidade nº 4492, at the Federal Supreme Court of Brazil

[18] Regarding "judicialização" e seus desdobramentos, see MACIEL, Débora Alves e KOERNER, Andrei. "Sentidos da judicialização da política: duas análises", Sao Paulo: Lua nova: Revista de Cultura e Política, nº 57, 2002.

[19] Article 27 of the Federal Mexican Constitution (Constitution), paragraphs 4 and 6 and article 1 of the Statutory Law of Article 27 of the Constitution in the Petroleum Sector (Ley Reglamentaria del Artículo 27 Constitucional en el Ramo del Petróleo herein Statutory Law published on the Federal Official Gazette on 29 November 1958, last amendment as of 28 November 2008).

[20] The activities of the Mexican State within the strategic areas are the following: postal service, telegraphs, radiotelegraphy, oil and all hydrocarbons, basic petrochemicals, radioactive minerals and nuclear energy production, electricity, banknote issuing and minting of coins as well as other activities pointed out by the Congress. See article 28 of the Constitution and article 5 of Foreign Investment Law

The Statutory Law of Article 27 of the Constitution in the Petroleum Sector (Statutory Law)[21] provides in article 2 that only the Mexican Nation shall carry out the exploitation of hydrocarbons which constitute oil industry. Said industry covers:

1) exploration, exploitation, refining, transportation, storage, distribution and first-hand sales of oil and by-products obtained from its refining;

2) exploration, exploitation, processing and first-hand sales of gas,[22] as well as essential and necessary transportation and storage to interconnect their exploitation and processing, save associated gas with deposits of mineral coal;[23]

3) production, transportation, storage, distribution and first-hand sales of derivatives of oil and gas that serve as basic industrial raw materials which are considered basic petrochemicals, such as: ethane, propane, butane, pentanes, hexane, heptanes, material feedstock for smoke lampblack, naphtha, and methane from hydrocarbons located in Mexico and used as basic industrial material in the petrochemical industry.

Mexico carries out the exploration and exploitation of oil and the aforementioned activities through Petróleos Mexicanos (PEMEX) and its subsidiary entities. Nevertheless, transportation, storage and distribution of gas may be carried out, prior permission, by the social and private sector which may build, operate and be owners of ducts, facilities and equipment in terms of regulations.[24]

The Mexican regulatory framework of petroleum is in accordance with international law and particularly with free trade agreements.[25]

(Ley de Inversión Extranjera published on the Federal Official Gazette on 27 December 1993, last amendment as of 20 August 2008).

[21] Statutory Law see note 19.

[22] Once the first-hand sale is executed, the private sector may participate in the transportation, storage, distribution in accordance with the regulation. See PÁRAMO FERNÁNDEZ, Marcelo. "Conceptos Jurídicos sobre la regulación del Gas Natural y del Gas Licuado de Petróleo en México" *Regulación Energética Contemporánea.* Porrúa – ITAM, México, 2009 p. 465.

[23] Mining concessionaires may opt to exploit the gas associated with mineral coal in the productive process or deliver the gas to PEMEX and it shall cover the fixed price by the Ministry of Energy. Mining Law (Ley Minera published on the Federal Official Gazette on 26 June 1992, last amendment as of June 26, 2006) regulates the recovery and use of gas associated with mineral coal. See article 19, paragraph XIII of Mining Law and article 4 of Statutory Law.

[24] Article 4 of Statutory Law.

[25] Mexico reserved strategic areas in various Free Trade Agreements (FTA), for instance, see Annex 602.3 of the NAFTA; Annex III of the FTA between Mexico and Chile; Section 1, Annex 8 referred to in Chapter 7 of the FTA between Mexico and Japan.

ii. PEMEX

PEMEX is a decentralized entity with productive purposes, with its own patrimony and legal personality and it is responsible for the Strategy and operational decision making.[26] PEMEX is provided with decision-power over debt acquisition with Ministry of Finance oversight.[27] Likewise, it is allowed a budgetary freedom when it comes to core-business investment projects and flexibility in other budgetary issues.[28]

PEMEX is run by a CEO with oversight from the Board of Directors.[29] The duties of the Board of Directors include approving, authorizing, programming, budgeting, financing, investing and evaluating PEMEX and its subsidiaries, as well as regulating the public works, acquisitions, lease and services to be provided to PEMEX among other tasks.

In order to achieve an adequate performance of the tasks mandated, the Board of Directors is assisted by the following Committees: i) Auditing and Performance Evaluation, ii) Investment and Strategy, iii) Remunerations, iv) Acquisitions, Leases, Works and Services, v) Environment and Sustainable Development, vi) Transparency and Accountability and vii) Development and Technological Innovation.[30]

The performance of PEMEX shall be reviewed by the Auditing and Performance Evaluation Committee, an Examiner appointed by the Executive branch, the Internal Control Department, the Federal Superior Auditing and by an External Auditor.[31] PEMEX shall submit to the Congress an annual report containing the status of PEMEX and its subsidiaries as well as the financial statements among other issues.[32]

The organizational structure of PEMEX comprises the following subsidiary entities:

a) PEMEX Exploración y Producción (Exploration and Production),

b) PEMEX Refinación (Refining),

c) PEMEX Gas y Petroquímica Básica (Gas and Basic Petrochemical),

d) PEMEX Petroquímica (Petrochemical),

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[26] Article 3 of PEMEX Law published on the Federal Official Gazette on November 28, 2008.
[27] Public debt shall not grant to its debt holders any rights over the property, control or patrimony of PEMEX. See article 44 of PEMEX Law.
[28] PEMEX Law, article 49.
[29] Ibid. article 7.
[30] Ibid. articles 22 – 30.
[31] Ibid. articles 33 to 35.
[32] Ibid. article 70.

e) P.M.I. Comercio Internacional, S.A. de C.V. (PMI International Trading)[33]

PEMEX and its subsidiaries have independent legal status and patrimony created for productive purposes of providing and managing all the activities related to Mexican petroleum industry.[34] Private participation in PEMEX or in its subsidiaries, either domestic or foreign, is forbidden by law.

iii. Other related entities

The following public entities are also involved in the regulation of oil and gas:

α) The Ministry of Energy is in charge of the administrative application of the Statutory Law with the participation of the Energy Regulatory Commission (CRE by its acronym in Spanish) and the Hydrocarbons National Commission.[35] Moreover, the Ministry shall exclusively grant to PEMEX and to its subsidiary entities the assignment of zones for the exploration and exploitation of oil.[36]

β) CRE: The objectives of CRE are to promote the efficient development of the following activities:

a. The first-hand sale of gas, fuel oil and basic petrochemical products;

b. The gas transportation and distribution of products obtained from oil refining and basic petrochemicals, which are carried by pipeline and storage systems linked to the transmission or distribution systems by pipeline;

c. The transportation and distribution by pipeline of bio-energy products as well as the storage linked to the transmission or distribution systems by pipeline.

In order to comply with its objectives CRE may act as mediator or arbitrator in the dispute resolution process of the aforesaid activities as well as other related to electric energy.[37]

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[33] It is a stock corporation, incorporated in 1989. The main stockholder is PEMEX (98.33 per cent).
[34] PEMEX Law, Article 6 paragraph 3. PEMEX is allowed to incorporate as many subsidiaries as needed for the development of the oil and gas industry (articles 3 and 6 of Statutory Law).
[35] Statutory Law, article 16.
[36] Ibid. article 5.
[37] Articles 2 and 3 of the Energy Regulatory Commission Law (Ley de la Comisión Reguladora de Energía published on the Federal Official Gazette on 31 October 1995, last amendment as of 28 November 2008).

χ) Hydrocarbons National Commission. The objectives of this Commission are not only to regulate and supervise the exploration and extraction of hydrocarbons, located in deposits but also processing, transportation and storage related to the exploration and extraction projects.[38]

δ) National Energy Council shall propose to the Ministry of Energy criteria and elements of energy policy; as well as assistance in the energy planning and it shall participate in the development of the National Energy Strategy.[39]

2. Political and Economic Implications

a. Petrobras

The constitutional criteria of 1997 which eliminated some of the privileges granted to Petrobras in 1954, established political and economic factors. From a political point of view, in 1997, during the Government of Fernando Henrique Cardoso, there was a significant change that involved and open economic model. Therefore, President Cardoso, was considered to be neoliberal and a politician of privatizations. At the same time, Petrobras developed technically and scientifically, such development allowed the execution of some activities by itself avoiding the participation of third parties.

The discovery of the *pre-salt* occurred in the second administration of President Lula da Silva, a former opponent of Fernando Henrique Cardoso, who had preceded him in power. The effective exploitation of these deep water fields, however, occurred in the government of President Roussef, elected in October 2010.

Moreover, in 2010, the year of the presidential campaign, most of the laws that regulate the prodigious reserves of the *pre-salt* were published (some laws were published even in the last hours of Lula's government in December 2010). The debate that preceded it was intense and lasted for almost three years.

[38] Hydrocarbons National Commission Law (Ley de la Comisión Nacional de Hidrocarburos published on the Official Gazette of the Federation on 28 November 2008) article 2.
[39] Rules for the National Energy Council (Reglas de funcionamiento del Consejo Nacional de Energía) published on the Federal Official Gazette on 31 July 2009.

Thus, it is possible to infer that, somehow, the laws that govern the oil exploration and production of *pre-salt* are the result of the election campaign of 2010 (virtually started in 2008) and the Brazilian political debate. The discussion of these new provisions has deeply affected the Brazilian economy and particularly São Paulo stock exchange (BMF Bovespa); at the same time, the company's performance is driven by the circumstances of the Brazilian economy, especially given the challenge of capitalizing the exploratory adventure into the seas called *pre-salt*.

It is important to examine the legal framework of the new legislation made in 2010, in order to understand the relation between economics and politics in the management of Petrobras, mainly because of the future challenges. Law is always a result of local culture, politics and economics. The standard and most troubled of the greatest economic impact is the common way in which the company will be capitalized in order to cope the high investments of intended operation. This is Law No. 12,276 of June 30, 2010.

Law No. 12.276/10 returns to the past. Petrobras may take five billion barrels of oil as a way to raise funds for future exploration of the *pre-salt*, without bidding. In other words, the initial and most accessible reserves of oil will be extracted exclusively by Petrobras, taking advantage of this special condition, in order to ensure the financial health for future and ongoing surveys that require *pre-salt*. This operation was preceded by another, a record-breaking IPO - involving about 69 billion dollars - having the same purpose: to capitalize the company and give conditions to strongly act in the new context. [40]

In this sense:

> Similarly, Law No. 12276/10 (one of the approved laws), also aimed to strengthen Petrobras' power to the extent it authorized the Federal Union to assign to Petrobras prospecting and the extraction activities of oil, gas and other hydrocarbons of *pre-salt* area, not previously granted to third parties, dismissing the requirement of public bidding, subject to the payment, which may be effective through government bonds. The Model to be followed under these circumstances is total risk assumption by Petrobras

[40] Law nº 12.276 provides as follows: *Fica a União autorizar a ceder onerosamente à Petróleo Brasileiro S.A. - Petrobrás, dispensada a licitação, o exercício das atividades de pesquisa e lavra do petróleo, de gás natural e de outros hidrocarbonetos fluídos de que trata o inciso I do artigo 177 da Constituição Federal, em áreas não concedidas localizadas no pré-sal. Parágrafo 1º - A Petrobrás terá a titularidade do petróleo, gás natural e outros hidrocarbonetos fluídos produzidos nos termos do contrato que formalizar a cessão definitiva no caput. Parágrafo 2º - A cessão de que trata o caput deverá produzir efeitos até que a Petrobrás extraio o número de barris equivalentes de petróleo definido em respectivo contato de cessão, não podendo tal número exceder a 5.000.0000.0000 (cinco bilhões) de barris equivalentes de petróleo. Parágrafo 3º - O pagamento devido pela Petrobrás pela cessão de que trata o caput deverá ser efetivado prioritariamente em títulos da dívida pública mobiliária federal, precificados a valor de mercado...*

> with ultimate ownership of the volumes of oil and gas produced up to five billion barrels oil equivalent (BOE). Hence, this is an exception to the production sharing model. The onerous assignment to Petrobras contract grants the exploration rights of certain areas for the price of almost USD$ 43 billion.
>
> In order to raise funds for paying such exploration rights and to secure the financial needs in the exploitation of the *pre-salt* areas, Petrobras performed offer the public record with the capitalization of more than USD$ 69 billion. As per an authorization from Law No. 12276/10, the Federal Union subscribed from Petrobras shares at the public offer, paying for government bonds with them. [41]

It is clearly a political decision by the Federal Government to change what had been established after the Constitutional Amendment 09/95. The capitalization of Petrobras forced a new and particular regime. With the acquisition of a differentiated position in relation to other oil companies and especially with the investment through subscription of shares, the company took back a different status, a result of the interaction between politics and economics. This new model is called the onerous assignment.

The terms of Law No. 12.276/10 are being analyzed by the Supreme Court. This new regime, established by the Law 9478/97, stipulates that the amounts owed to states and municipalities as equity arising out of oil (called royalties) are not reset.

For this reason the government of the State of Rio de Janeiro,[42] disagreed with the capitalization of Petrobras without bidding the first 5 billion barrels of oil. These basins were already governed by the old regime, in which any company could perform the operation, and the states involved could receive the royalties of this transaction. However, the declaration that these areas are also *pre-salt* reserves implied that they were governed by the new burdensome concession regime and, with it; all resources (up to a limit of 5 billion barrels) shall be extracted from it for the capitalization of Petrobras in order to obtain resources for new oil frontiers.

By this single incident we can appreciate the entire economic and political complexity (and therefore also legal) of the previous models and contemporary regulations of the *pre-salt*. This picture is further enhanced by the fact that Law No. 12.351/10 set for other companies who wish to participate in the operation plus a new legal and economic framework.[43]

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[41] DRAGO, Bruno. "Pré-salt: a new legal framework for the oil industry in Brazil". Available at www.mondaq.com, recuperado em fevereiro de 2011.

[42] The closest and most recognized basin of *pre-salt* oil and therefore the first in which oil will be withdrawn is in the State of Rio de Janeiro.

[43] ADI 4492, tramitando no Supremo Tribunal Federal, available at www.stf.jus.br

Law No. 12.235/10 establishes that other companies shall explore the *pre-salt* area with the "production sharing regime" (production sharing). In this new model, Petrobras also has a prominent position, but allows the sharing of production with the company that wins the bidding for a particular field.

In the sharing model, Petrobras will always deter the operator position. This means that it shall conduct the exploration and production, providing the critical resources (technology, personnel and material resources) for the activity. The major criterion of choice for the private company in the bid will be the largest offering of "oil profit." In all these transactions, the Union acts in a consortium in which Petrobras holds a 30 per cent immediate right and it can also participate in biddings to increase its interest beyond this minimum.

Thus, in the production sharing regime Petrobras can act on behalf of the Union (when it will hold 100 per cent of the amount earned) or with private companies, Petrobras has a 30 per cent share of income and it maintains as carrier.

It is important to notice that in the regime of co-production, operating risks are fully borne by the contractor.

Law 12.304/10 created a new state company that shall participate in the management of *pre-salt*. Its incorporation and the structure to manage these new oil resources were intensely discussed in the parliamentary debate. The officers of Lula's Government were accused several times, to avail themselves of public infrastructure. Amid the presidential campaign of 2008 and 2009, the official acts of President Lula were considered by the Electoral Tribunal as prohibited by law campaigns because of the use of public structure and resources.

The creation of a new state company and the contracts that emerge would reveal, even to the opponents, the growing trend of undue and naughty interference in the Brazilian economy. With a large majority in the Congress, the law that created the Pre-salt Petroleum SA (PPSA) was enacted.

The role of the PPSA is not confused with Petrobras. The objective of PPSA is to participate in the production-sharing consortia, involving the Ministry of Mines and Energy, the National Petroleum Agency, the bidding companies and Petrobras. In terms of Article 2, it will never be responsible for implementation, directly or indirectly, of exploration, development, production and marketing of oil. It is just a manager, an agent of the Union in the consortia.

A number of questions may be raised by those who disagree with the new laws due to the compulsory participation of Petrobras and the costly concession arrangement. The sharing scheme has no competition. These factors have led to unrest and promoted a number of

uncertainties for the investors, just in time, when Petrobras needs more resources.

Consequently, this chain of economic, political and legal uncertainties affects the management of Petrobras and the model dispute resolution, including arbitration.

b. Mexico

PEMEX is the largest company in Latin America. In 2008, Mexico was the 6th world oil producer and the 10th exporter. Notwithstanding this, the Mexican oil sector presents important challenges. The production is now in decline, particularly in the most productive oilfields, including the giant Cantarell, e.g., in 2004 PEMEX produced 3.4 million barrels per day, and in 2008 the production declined to 2.8 million barrels per day.

Therefore, PEMEX has turned its attention to other fields that present complex technical challenges, including low well productivity. PEMEX seeks to be competitive on a global scale, starting with its relationships to suppliers and international operating companies. Exploration and development targets are:

- Matures fields of the south and north basins, where proved reserves represent 29 per cent of Mexico's total reserves,
- Chicontepec, where 39 per cent of the country's petroleum reserves are located, and
- Deepwater areas of the Mexican portion of the Gulf of Mexico, where there are yet undiscovered resources estimated at 28 billion barrels of oil equivalent.[44]

In addition, Mexico imports significant amounts of petrochemicals, for instance, 41 per cent of the gasoline consumed in the country is imported. Most of the infrastructure is obsolete and there are no facilities to capture the gas associated with oil. Apart from that, there is an excessive tax burden. In 2007, around 38 per cent of the federal revenues were provided by PEMEX.[45]

The current regulation of PEMEX and the oil sector (in force since 2008) purports to confront these challenges by strengthening corporate governance and creating a new contractual framework.

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[44] Petróleos Mexicanos, *Integrated EP Contracts*, 2010 available at: http://www1.pep.pemex.com:8080/contratos/eng/intro.html

[45] GIL VALDIVIA, Gerardo. "Financiamiento de Proyectos de Infraestructura del Sector Energético," *La Infraestructura Pública en México (Regulación y Financiamiento).* UNAM, México, 2010, p. 99.

The contracts aim to increase its capabilities in Chicontepec and deepwater, where projects will require distinct economic and operational models.[46]

The participation of foreigners and nationals in the oil sector is limited by the Constitution of 1917. The interests of investors remained unaffected, until 1938 when President Lázaro Cárdenas expropriated private interests over oil and gas industry, creating a national monopoly for the Mexican Nation that remains to-day. However, the current contractual framework allows foreigners to participate in tender procedures for contracting with PEMEX.

Opponents of the Government of President Felipe Calderón challenged the constitutionality of PEMEX Regulations. However, the Supreme Court declared that PEMEX Regulations are in conformity with PEMEX Law except for an article. Therefore, the new contracting framework is safe.[47]

Since the decade of 1990s Mexico adopted arbitration for managing dispute resolution in various laws concerning oil and gas, electrical energy, telecommunications, airports, civil aviation, intellectual property, acquisitions and public procurement.[48] Since then, PEMEX and its subsidiary entities have been involved in many national and international arbitration proceedings.

3. Dispute Resolution

a. Brazil

We should recall that the Union exercises the monopoly (the ownership and not the activity) of oil exploration in three different ways, depending on the area:

- Areas outside the *pre-salt* regime of concessions (Law nº 9478/97)
- *Pre-salt* areas by up to 5 billion barrels of oil: Onerous assignment exclusively granted to Petrobras (Law No. 12.276/10).

[46] Petróleos Mexicanos, op. cit.

[47] Controversia Constitucional 97/2009, Cámara de Diputados del Congreso de la Unión. Judge Margarita Beatriz Luna Ramos.

[48] RODRÍGUEZ MÁRQUEZ, José Antonio. "Legislación Mexicana Sobre Arbitraje" *Diccionario Enciclopédico de Arbitraje Comercial,* Ed. Cecilia Flores Rueda, Themis, México, 2010 p.183.

- *Pre-salt* areas, to be defined and to be granted directly to private companies or Petrobras, in a consortium in which Petrobras is the operator, and third parties can participate by bidding for production sharing arrangements (Law No. 12.351/10).

Each of these schemes has specific characteristics. Political and economic issues influenced the special features dealing with conflict prevention and dispute resolution.

Petrobras has traditionally been a major player in international arbitration procedures regarding oil industry.[49] As a private company managing exploration platforms in several countries of Latin America and worldwide, Petrobras underwent systematically to international arbitrations procedures arising by the arbitration clauses agreed in the different contracts that it executed. [50]

However, it is surprising the fact that the Attorney General's Office speak out forcefully against the use of arbitration in matters involving the *pre-salt* areas.[51] Arbitration is an important mechanism for stabilizing business relations and grants security to those involved in long-term contracts.[52] Therefore, we cannot infer the inconvenient of not submitting to arbitration.

We must stress out that the refusal of the Attorney General confines itself exclusively to the onerous assignment in which Petrobras operates for the benefit set by law, on behalf of the Union through its relationship with the National Petroleum Agency. In this scheme, Brazilian Federal Public Attorney says there would be no reason to invoke the rules and institutions of international arbitration, since it would be orbiting the federal public sphere itself.

In the operation regime of areas unrelated to the *pre-salt* model (concession) and in those *pre-salt* areas with other companies (model production sharing) there is no legal obstacle to enter into arbitration agreements.

A positive aspect of this situation is that the opinion recognizes the strong influence of arbitration in Brazil; however it eliminates arbitration in Petrobras onerous assignment.

Actually, it is really difficult to imagine in which way they would have an international

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[49] See PINTO, Jose Emilio Nunes."A Arbitragem nos Contratos da Indústria de Petróleo e Gás Natural" in Paulo Valois (org.), *Temas de Direito do Petróleo e do Gás Natural II*, Rio de Janeiro: Lumen Juris, 2005.

[50] See, for example, the case Petrobrás X Transcor Astra Group, October 2008, International Centre for Dispute Resolution – ICDR, USA.

[51] The opinion of the Attorney General's Office was made public and is available at www.agu.gov.brwww.agu.gov.br

[52] See, SILVA, Eduardo Silva da. *Arbitragem e Direito da Empresa.* São Paulo: Editora Revista dos Tribunais, 2003.

arbitration involving Petrobras, the Union and the National Petroleum Agency which are the parties in the onerous assignment consortium.

There is a policy option, a board of mediation and arbitration of the Federal Administration. This does not seem misplaced and not against of Brazilian domestic arbitration law.

Due to the many factors of insecurity, economic and political unrest that characterize the Brazilian *pre-salt*, we can understand that the system of dispute settlement is not the most important problem. Brazil considers of great risk arbitration, therefore, it prefers disputes between their internal organs to be resolved by a board of government officers. Disputes between Petrobras, the Union and other companies may be submitted to arbitration. Notwithstanding the above, the onerous assignment in *pre-salt* areas is excluded from the ADR method.

b. PEMEX

i. Contracting Framework

PEMEX and its subsidiary entities are allowed to execute any acts, agreements, contracts and issue negotiable instruments, maintaining the exclusive ownership and control of the Mexican State on hydrocarbons.[53] However, contracting within the framework of PEMEX Law varies depending on subject matter of the activities. The following regulation governs when contracting with the private sector:[54]

α) **Substantive activities**: The acquisition, leases, services and works contracts regarding substantive activities with productive character[55] shall be governed by PEMEX Law, its Regulations and the Procurement Administrative Provisions.[56]

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[53] See PEMEX Law, articles 5 and 60.

[54] Ibid. article 52.

[55] Pursuant to Article 2 of the Regulations of PEMEX Law, the term "Substantive Activities with Productive Character (Actividades Sustantivas de Carácter Productivo)" stands for activities comprising the Oil State Industry (see section i for the activities covered by the Mexican oil industry), non-basic petrochemical and all other activities that PEMEX and its subsidiaries shall perform according to Statutory Law.

[56] Procurement Administrative Provisions (Disposiciones administrativas de contratación en materia de adquisiciones, arrendamientos, obras y servicios de las actividades sustantivas de carácter productivo de Petróleos Mexicanos y Organismos Subsidiarios known by its acronym in Spanish as DACs) published on the Federal Official Gazzette on 6 January 2010, last amendment as of March 10, 2010.

β) **Non-substantive activities**: The acquisition, leases, services and works that not be deemed substantive activities with productive character such as purchase of materials and equipments for PEMEX's offices, construction of administrative buildings, etc.[57] shall be governed by the Public Acquisitions, Leases and Services Law (Acquisitions Law) and the Public Works and Related Services Law (Works Law) and its corresponding Regulations.[58]

In addition to the above, there are certain special contracting features of importance. PEMEX and its subsidiary entities may execute works and services contracts for the best performance needed of its activities prior bidding procedure. Such contracts shall stipulate the Mexican State domain over hydrocarbons as well as its control and direction of oil industry and payment of remunerations in cash. Furthermore, contracts shall not grant any right over oil reserves; consequently, contractors may not register them as assets. Contracts may include clauses for the modification of projects due to the incorporation of new technology, market prices variation, the acquisition of new information obtained during the execution of the works or other clauses that permit to improve the efficiency of the project.[59] Production-sharing agreements, participation agreements or any agreement which share percentage in the production or the value of the sale of hydrocarbons or its by-products are forbidden by law.[60]

Notwithstanding the above, PEMEX Law and its Regulations allows for contracts that would provide remuneration based on a proportional scale to contractors whose efforts produce superior outcomes by incorporating the latest technology.[61] We consider that these goals can be easily achieved by any major oil company, due to the fact that PEMEX technology is obsolete and inefficient.

[57] LÓPEZ VELARDE, Alejandro "The new foreign participation rules in each sector of the Mexican oil and gas industry: Are the modifications enough for foreign capitals?" *Journal of World Energy Law & Business*, Vol. 3 (2010) p. 81.

[58] Public Acquisitions, Leases and Services Law (Ley de Adquisiciones, Arrendamientos y Servicios del Sector Público) published on the Federal Official Gazette on 4 January 2000, last amendment as of May 28, 2009 and Public Works and Related Services Law (Ley de Obras Públicas y Servicios Relacionados con las Mismas) published on the Federal Official Gazette on 4 January 2000, last amendment as of May 28, 2009.

[59] Article 60 of Statutory Law

[60] Article 6 of Statutory Law, article 55 of the DACS

[61] PEMEX Law, article 61 section VI and Pemex Regulations article 62

ii. Arbitration and ADR

a) General

The Federal Congress has the power to legislate over hydrocarbons.[62] In accordance to article 9 of the Statutory Law oil industry and its activities are part of the federal jurisdiction; consequently, only the Federal Government may regulate the technical provisions and the applicable regulatory framework.

Mexican Constitution foresees alternative dispute resolution mechanisms in which arbitration is included.[63] Nevertheless, Federal Courts are the competent courts having proper jurisdiction over disputes involving state entities according to article 104 of the Constitution. Such provisions, however, do not prohibit that state or public entities agree to solve disputes by means of arbitration or alternative dispute resolution (ADR) methods.

The provisions of Statutory Law regulate oil sector and a superior relation over PEMEX Law may be deemed because Statutory Law appoints the existence of PEMEX.[64]

Regarding forum selection clause and the place of arbitration article 6 paragraph 2 of the Statutory Law states that PEMEX "*shall not, in any case, submit to foreign jurisdictions with regard to disputes referred to in works and services contracts in the national territory or in the zones where the Nation exercises sovereignty, jurisdiction or competence. Contracts may include arbitration agreements in accordance with Mexican laws and international treaties to which Mexico forms part.*"

From the above-mentioned articles we can infer the following:

a. Federal Courts shall have jurisdiction over disputes related to PEMEX and its subsidiary entities. Notwithstanding the above, an exclusive jurisdiction of the Federal Courts may not be considered due to the possibility to opt for arbitration.[65]
b. Article 6 seems to limit arbitration to works and services contracts.
c. If parties agree a forum selection clause, they shall submit to foreign jurisdictions only when works and services contracts are abroad.

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[62] Federal Constitution, article 73 paragraph X

[63] Ibid. article 17

[64] The Collegiate Circuit Courts have construed the existence of a relation of subordination between two general laws depending on the capacity of creation of one law. Therefore, the law that foresees and determines the creation of other law is superior to the last one. There is a superior law when its articles determine the creation of other law. See Eight Period, Registry: 231542, Instance: Collegiate Circuit Courts, Isolated Thesis, Source: Semanario Judicial de la Federación I, Segunda Parte-1, January – June 1988, Subject(s): Administrative, Page: 394 LEYES, PRINCIPIO DE JERARQUIA NORMATIVA (DE LAS), ESTABLECIDO POR EL ARTICULO 133 CONSTITUCIONAL.

[65] See RODRÍGUEZ JIMÉNEZ, Sonia. *Competencia Judicial Civil Internacional*, Instituto de Investigaciones Jurídicas de la UNAM, México, 2009 pp. 107-119.

d. If the contract provides with an arbitration agreement, the place of the arbitration shall be in Mexico with regard to works and services to be performed in Mexico. Furthermore, the place of arbitration may be agreed abroad if works and services take place outside of Mexico. A point of connection may be inferred from the place of execution of the works and services.[66]

Pursuant to article 12 of Statutory Law the acts of the oil industry as well as the transport, storage and distribution of gas carried out by the private or social sector, are deemed to be commercial, and shall be governed by the Commercial Code and Federal Civil Code. The second code has a complementary role. The Fourth Title of the Fifth Book of the Commercial Code contains the Mexican *lex arbitri* which is a legislation based on the UNCITRAL Model Law on International Commercial Arbitration as adopted in 1985. Arbitration, therefore, shall be governed by the provisions of the Commercial Code.

The last paragraph of article 52 of the Regulations of Statutory Law[67] provides with the possibility to file an administrative remedy against acts and resolutions that terminate administrative procedures if parties have not opted for arbitration under the Statutory Law, in the following cases: 1) Services exclusively provided by the State through Decentralized Organizations and 2) Contracts that may only be entered into between third parties and the Decentralized Organizations. From a proper interpretation of the aforesaid article it is possible to infer that rescission of such contracts and any other administrative acts which terminate administrative procedures are arbitrable disputes.

b) Substantive activities with productive character

As was stated above, substantive activities with productive character are governed by PEMEX Law, its Regulations and the Procurement Administrative Provisions. Such regulatory framework foresees the possibility to solve disputes by alternative dispute resolution mechanisms, included arbitration.

According to Article 5 of PEMEX Law General Managers of PEMEX and its subsidiary entities have powers of attorney to perform the execution of arbitration agreements.

With regard to national disputes article 72 of PEMEX Law stipulates that legal acts executed by PEMEX and its subsidiary entities shall be governed by federal applicable laws. Federal Courts shall be competent courts having proper jurisdiction over any dispute save there is an arbitration agreement. Nevertheless, PEMEX and its subsidiary entities may agree to apply

[66] See WÖSS, Herfried. "Arbitraje, Medios Alternativos de Solución de Controversias y Compras del Sector Público en México" *Revista Latinoamericana de Mediación y Arbitraje,* Vol. XI, No. 2 (2009) pp. 133 available at http://www.med-arb.net/

[67] Regulations of Statutory Law (Reglamento de la Ley Reglamentaria del Artículo 27 Constitucional en el Ramo Petrolero) published on the Federal Official Gazzette on 22 September 2009.

foreign law, the jurisdiction of foreign courts in commercial matters, and arbitration agreements regarding legal acts of international character in order to accomplish its tasks.

The aforesaid provisions not only regulate forum selection clause or arbitration for services and works contracts as Statutory Law does, but they also provide a broader contracting regulatory framework. Likewise, the provisions are in accordance with Statutory Law. Either national or international matters may be resolved by arbitration. PEMEX and its subsidiary entities may agree submission to foreign courts and the application of foreign law with regard to international transactions. Consequently, if an international contract stipulates an arbitration agreement, the place of the arbitration may be outside of Mexico.

Article 64 of the Regulations of PEMEX Law[68] states that the Procurement Administrative Provisions shall establish the causes, proceedings and effects of administrative rescission, early termination and partial or total suspension of contacts to carry out the acquisition, leasing, works and services for the substantive activities with productive character. In addition, the rescission proceeding executed by the subsidiary entities shall be of administrative nature and shall not require judicial or arbitral resolution.[69] Nevertheless, article 71 of the Procurement Administrative Provisions provides that contracts shall stipulate the requirement of competent authority's resolution if the contractor requests the rescission of the contract.

It is important to emphasize that there is no provision in PEMEX Law, in the Regulations, or in the Procurement Administrative Provisions expressly precluding the arbitrability of the administrative rescission or early termination as the Acquisitions Law and the Works Law do.[70] This is an important change in legislative tradition because administrative rescission and early termination are considered acts *jure imperii* and not subject to arbitration under Acquisitions Law and the Works Law.[71]

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[68] Regulations of PEMEX Law (Reglamento de la Ley de Petróleos Mexicanos) published on the Federal Official Gazzette on 4 September 2009.

[69] Article 70 of the Procurement Administrative Provisions confirms that PEMEX and its subsidiary entities may administratively rescind any contract without the need for a judicial or arbitral resolution. Such rescission shall have full effect once it has been determined and notified to the Supplier or contract.

[70] Article 80 of the Acquisition Law and article 98 of Works Law.

[71] Under Works Law the matters which do not fall within the competence of the arbitral tribunal and which may not be deemed as arbitrable are the rescission and early termination of the contract. Under the provisions of Acquisitions Law (article 80), arbitration agreement may only be entered into with regard to those disputes derived from long-term services contracts in terms of the Mexican *lex arbitri*. Furthermore, administrative rescission and early termination may not be subject to arbitration. Acquisitions Law (articles 77-79) and Works Law (articles 95-97) provide with rules for conciliation. Conciliation proceedings shall be conducted by the Ministry of Public Administration. In addition, Works Law (article 102) and Acquisitions Law (article 84) foresee the possibility to agree other alternative means of dispute resolution if they are acknowledged by Ministry of Public Administration through general provisions. However, the Ministry has not issued such regulations.

Therefore, we can infer from the above that regarding substantive activities contracts, early termination and rescission requested by the Contractor may be submitted to arbitration, save there is a provision limiting this in the contract.

Moreover, Procurement Administrative Provisions are arbitration-oriented regulations. As a matter of fact article 68 states that in the case a contract does not include any arbitration clause parties may stipulate an arbitration agreement in the terms established for this purpose by the Legal Department, for those disputes that have not been finally resolved through the mechanisms agreed in the contract.

Clauses 25.1 and 25.4 of the Generic Service Contract Specimen for the Evaluation, Development and Production of Hydrocarbons (Generic Contract Specimen),[72] (English version) state the following:

> **25.1 Applicable Law.** The Contract shall be governed by and construed in accordance with the laws of Mexico. At all times during the term of the Contract, the Contractor shall comply with the provisions of the Applicable Laws regarding management and execution of the Services.
>
> **25.4 Arbitration.** Any dispute or claim arising in connection with the contract which has not been surpassed by any dispute resolution mechanisms provided for in the Contract, including legal issues related to the appointment of the Independent Expert or with the decisions he/she issues shall be settled exclusively by arbitration in accordance with the Rules of Arbitration of the International Chamber of Commerce. The governing applicable law shall be the one stipulated in Clause 25.1. The arbitration court[73] shall comprise three members, one appointed by PEP, one appointed by the Contractor, and the third one, who shall act as the president, appointed in accordance with the regulation[74] of International Chamber of Commerce. The arbitration shall be conducted in Spanish. The arbitration proceedings shall be held in Mexico City, Federal District.
>
> **25.5 Waiver of Embargo Prior to Award.** By means of this Contract, the Parties, on their own behalf and of their Related Companies, waive any and all rights they have or may have to seek and receive Embargos Prior to Award. Any Party that seeks an Embargo Prior to Award shall be deemed to have breached this Contract. In case of breach of this Clause 25.5, the non-breaching Party shall be entitled to a reimbursement by the breaching Party of all costs and expenditures incurred, including reasonable attorneys' fees, without prejudice to any other resources that the non-breaching Party is entitled to exercise.

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[72] The English version of the Generic Service Contract Specimen for the Evaluation, Development and Production of Hydrocarbons is available at:
http://www.pep.pemex.com:8080/contratos/eng/pdf/ContractModel.pdf

[73] The Spanish version of the Generic Services Contract refers to "*tribunal arbitral*" (arbitral tribunal) instead of arbitration court as the English version does. Under article 2 of the Rules of Arbitration of the International Chamber of Commerce (ICC)*"'Arbitral Tribunal' includes one or more arbitrators."*

[74] It would be better to place the word "rules" instead of regulation.

The Generic Contract Specimen does not limit the arbitrability of early termination nor rescission.

In accordance to article 63 of the Regulations of PEMEX Law PEMEX and its subsidiary entities are obligated to seek best practices for the efficient administration of contracts, foreseeing mechanisms in the contract to solve problems that arise during the execution, and where appropriate, the differences and disputes arising between the parties. If the differences are purely technical they may be submitted to the decision of an expert or experts appointed directly by the parties in the terms and conditions agreed in the contract.

In the event that the contract does not include any clause providing ADR, these mechanisms may, if PEMEX or its subsidiary entities deems it appropriate, be agreed by written agreement between the parties whether before or after the dispute. In addition, Contracts shall stipulate that Suppliers and Contractors may resort to arbitration when dispute resolution mechanisms have been exhausted in accordance with the contract.[75]

Additionally, the Ministry of Public Administration (Secretaría de la Función Pública) and the intern control bodies of PEMEX and its subsidiaries are competent authorities to resolve claims as well as conciliation proceedings regarding acquisitions, leasing, works and services of the substantive activities with productive character. These proceedings shall be governed by the Acquisitions Law and Works Law. [76]

The English version of the Generic Service Contract stipulates as follows:

> **25.2 <u>Direct Consultations.</u>** The Parties agree that in case that any dispute arises, they shall try to resolve it through a mechanism of direct consultations, in order to seek a negotiated settlement between the Parties. This phase of direct consultations shall begin with a communication directed by either Party to the other, with the understanding that either Party may terminate this stage at any time.
>
> **25.3 <u>Independent Expert.</u>** If Parties fail to reach an agreement on their differences in technical, operational matters or related to accounting issues, taxation and calculation of payments due according to the Contract, the Parties shall agree to be bound by the decisions of an Independent Expert (the "Independent Expert"). The Independent Expert shall act as expert and not as arbitrator. The Party wishing to submit an issue to the decision of the Independent Expert shall propose to the other Party three candidates on the list contained in Annex 13 in order to choose, if the procedure is accepted, from among them the Independent Expert within twenty (20) days. Each Party shall pay its own costs in relation to this procedure and the fees of the Independent Expert shall be

[75] Procurement Administrative Provisions, article 68.

[76] Article 67 of the Regulations of PEMEX Law.

covered by PEP and the Contractor in equal parts. Within thirty (30) days after the appointment of the Independent Expert as provided in this Clause 25.3, each Party shall provide him/her such information in its possession concerning the matter in dispute. The Independent Expert shall agree on one or more meetings with one or both Parties, to establish the specific matters in dispute and shall request additional information that is necessary. The Independent Expert shall issue his determination within thirty (30) days following the termination of the procedure, which shall not exceed ninety (90) days from the date of commencement, unless the Parties agree otherwise. The Parties shall update from time to time the list included in Annex 13 to ensure that at all times there is an adequate number of qualified experts in each category of disputes covered by this Clause 25.3, with the understanding that no party shall propose for appointment an expert who is a Related Company or is somehow associated with said Party.

c. Non-substantive activities

Pursuant to article 52 of PEMEX Law, acquisitions, leases, works and services of non-substantive activities with productive character are governed by Acquisitions Law and Works Law[77] and its corresponding Regulations.

Article 104 of Works Law and article 86 of the Acquisitions Law, both with the same wording, state that: "*Provisions of this chapter* [Third Chapter: Arbitration, ADR and Judicial Competence] *shall only apply to entities when their laws do not expressly regulate the form in which they can resolve their disputes.*"

It is important to determine whether the provisions of Works Law and Acquisitions Law concerning Arbitration, ADR and Judicial Competence apply to the acquisitions, works and services that do not form part of the substantive activities with productive character of PEMEX.

In addressing this question, we must consider the above provisions of the Statutory Law and PEMEX Law containing dispute resolution mechanisms. The regulation of dispute resolution is objectively evident in article 72 of PEMEX Law and article 6 of Statutory Law. Such provisions, therefore, shall also govern arbitration of non-substantive activities. As a consequence Acquisitions Law and Works Law shall not be applicable law, concerning arbitration, ADR methods and judicial competence.[78]

[77] See supra note 58.
[78] See supra note 71.

i. Gas and arbitration

As set forth above, the Energy Regulatory Commission may act as arbitrator or mediator of gas disputes.[79] The faculties of the Commission to mediate or arbitrate may have its origin in foreign regulatory agencies, e.g., the Federal Energy Regulatory Commission of the USA.[80] Administrative Law Judges (ALJ) act as settlement judges, mediators, facilitators, and arbitrators.[81]

The rationale on which an administrative authority has powers to resolve disputes between private parties derives on the utmost specialization required for technical business such as the gas industry.[82] The Mexican Energy Regulatory Commission, however, does not have specific officers to resolve arbitration procedures. Pursuant to article 4 of the Energy Regulatory Commission Law resolutions are given by the majority of the plenary session of the Commission. Consequently, the plenary session of the Commission is in charge to solve mediation and arbitration procedures with the assistance of different departments. The plenary session consists of five commissioners and the chairman holds a casting vote.[83]

The Energy Regulatory Commission Law provides in article 9 that without prejudice of the corresponding actions, disputes derived from regulated activities[84] may be resolved, at the discretion of the users, 1) by arbitration proceeding proposed by the parties performing such activities or 2) by the fixed proceeding by the Energy Regulatory Commission.[85]

This article presents a problem (*without prejudice of the corresponding actions*) because the competent courts are not subordinated to the arbitration agreement in sharp contrast to PEMEX Law. In addition, due to the discretion granted to parties, a party may opt to submit disputes to the competent courts instead of resorting to arbitration.[86] However, this problem should be

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[79] See supra note 37.

[80] See Alternative Means of Dispute Resolution 18 C.F.R. § 385.605 Arbitration (Rule 605).

[81] Federal Energy Regulatory Commission, *Administrative Litigation Functions,* at http://www.ferc.gov/legal/admin-lit/functions.asp

[82] PÁRAMO FERNÁNDEZ, Marcelo. op. cit. p. 477.

[83] LUJAMBIO IRAZÁBAL, José María. *Arbitraje y Mediación CRE* e-mail as of February 10, 2011.

[84] Under the Energy Regulatory Commission Law, Regulated Activities comprises: the first-hand sale of gas, fuel oil and basic petrochemical products; the gas transportation and distribution of products obtained from oil refining and basic petrochemicals, which is carried by pipeline and storage systems linked to the transmission or distribution systems by pipeline; the transportation and distribution by pipeline of bio-energy products as well as the storage linked to the transmission or distribution systems by pipeline; as well as other activities related to the electric energy sector.

[85] The original text provides that: "*Sin perjuicio de las acciones que procedan, las controversias que se presenten en las actividades reguladas podrán resolverse, a elección de los usuarios o solicitantes de servicios, mediante el procedimiento arbitral que propongan quienes realicen dichas actividades o el fijado por la Comisión.*"

[86] PÁRAMO FERNÁNDEZ, Marcelo. op. cit. p. 477.

solved in the permissions and contracts by stipulating an arbitration clause that would imply waiving the right to submit disputes to the competent courts. Nevertheless, in practice the dispute resolution clause is a faithful copy of this defective article.[87] Consequently, if there is no arbitration clause stipulated in the permission or in the contracts, the unique form to submit to arbitration under the provisions of the Mexican *lex arbitri*[88] would be entering into a written arbitration agreement afterwards the permission is granted or the contract is executed.[89]

Equally defective provisions appear in article 100 of the Liquefied Petroleum Gas Regulations[90] which states that claims and disputes derived from regulated services by these Regulations shall be subject to the following:

> X. For the resolution of disputes derived from the interpretation and compliance of the contracts executed in the terms of the Regulations, the Permittee or PEMEX may propose an arbitration proceeding to the Acquirers or end users. Acquirers or end users may opt for arbitration procedure proposed by the Permittee or PEMEX or the procedure established in the applicable law. If the dispute is resolved through arbitration, the award rendered shall be definitive.

Prima facie, it seems that arbitration is limited to "interpretation" and "compliance"; however, the wording of this article is part of the Legislative tradition. Wöss considers that the legislator may not be aware of the possible limitative effects. In addition, this terms "interpretation" and "compliance" do not have the intention of limiting the scope of jurisdiction of the arbitral

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[87] See, e.g. clause 11 "Dispute Resolution" of the Permission No. G/02/TRA/97 available at http://www.cre.gob.mx/registro/permisos/gas/g020tra97.html clause 11 of the Título de Permiso de Transporte de Gas Licuado de Petróleo por medio de ductos No. G/199/LPT/2007 granted to Penn Octane de México, S. de R.L. de C.V. en términos de la resolución No. RES/263/2007 as of August 2, 2007 available at: http://www.cre.gob.mx/documento/permiso/gas/G-199-LPT-2007.pdf and clause 25 of the Condiciones Generales para la Prestación del Servicio de Transporte de Gas Natural de Transportadora de Gas Natural de la Huasteca, S. de R.L. de C.V., concerning Solicitud de permiso de transporte a la CRE by Trans Canada, *Proyecto de Gasoducto Tamazunchale,* Sección E. – Condiciones generales para la prestación del servicio as of November 2004 p. 59. Available at http://www.cre.gob.mx/registro/permisos/gas/Anexos/160tra04/apex81.pdf

[88] See article 1416.1 of Commercial Code: "*arbitration agreement,* [means] *agreement under which the parties decide to submit to arbitration all or certain disputes that have arisen or that may arise between them with regard to a defined legal, contractual or non-contractual relationship.*" The text of article II.1 of the New York Convention is very similar.

[89] Article 1423 of Commercial Code provides that arbitration agreement shall be in writing signed by the parties or contained in an exchange of letters or other means of telecommunication that leave recorded the agreement. In addition, such article provides that the reference in a contract to a document containing an arbitration clause shall constitute arbitration agreement provided that the contract be recorded in writing and reference implies that such clause is part of the contract.

[90] Liquified Petroleum Gas Regulations (Reglamento de Gas Licuado de Petróleo) published on the Federal Official Gazette on 5 December 2007

tribunal. Therefore, the arbitral tribunal has jurisdiction to interpret the applicable law and to determine the validity of the arbitration agreement and the contract. [91]

Furthermore, under article 9 of the Energy Regulatory Commission Law, the arbitration procedure suggested as well as the competent entity to solve the disputes shall be registered in the Public Registry of the Energy Regulatory Commission. In the absence of specific procedure, it shall be determined by the Commission and the procedure shall be conducted by the Commission in accordance with the Mexican *lex arbitri*. The Commission has not issued special guidelines for arbitration procedures.[92]

The award rendered by Federal Energy Regulatory Commission as arbitrator, may be considered as an act of authority for all the effects of *amparo*[93] action.[94] In addition, the awards rendered by the Commission may constitute judicial acts. Therefore, the Commission may be exceptionally considered as a court of judicial nature.[95] Parties may be entitled to submit an *amparo* action before the federal courts if the award rendered by the Commission breaches fundamental rights of one party.[96]

For all the technical defects contained in the gas provisions, Prof. Páramo Fernández deems that arbitration proceedings are dead letter.[97] This statement was confirmed by José María Lujambio Irazábal, General Counsel of the Energy Regulatory Commission; however, the Commission has

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[91] WÖSS, Herfried. Op. cit. pp. 5 – 14.

[92] LUJAMBIO IRAZÁBAL, José María. op. cit.

[93] An appeal on the grounds of unconstitutionality.

[94] The awards rendered by the National Commission of Medical Arbitration, in its nature as arbitrator, constitute acts of authority for all the effects of amaparo action, because it acts on behalf of the State and as a public entity it establishes a relationship of subordination to the parties that submit to arbitration. See Ninth Period, Registry: 188434, Instance: Second Chamber of the Supreme Court, Jurisprudence, Source: Semanario Judicial de la Federación y su Gaceta XIV noviembre de 2001, Subject(s): Administrative, Page: 31 COMISIÓN NACIONAL DE ARBITRAJE MÉDICO. SUS LAUDOS ARBITRALES SON ACTOS DE AUTORIDAD PARA EFECTOS DEL JUICIO DE AMPARO.

[95] The awards rendered by the National Commission of Medical Arbitration constitute material judicial acts, because they resolve the merits of the dispute. Rendering awards are measures tantamount to a court of judicial nature. See Ninth Period, Registry: 176586, Instance: Collegiate Circuit Courts, Isolated Thesis, Source: Semanario Judicial de la Federación y su Gaceta XXII diciembre de 2005, Subject(s): Administrative, Page: 2638 COMISIÓN NACIONAL DE ARBITRAJE MÉDICO. COMPETENCIA EN AMAPARO CONTRA SUS ACTOS CUANDO FUNGE COMO ÁRBITRO, CORRESPONDE AL JUEZ DE DISTRITO EN LA MATERIA PROPIA DE LAS NOMRAS JURÍDICAS QUE REGULARON EL PROCEDIMIENTO ARBITRAL Y CONFORME A LA NATURALEZA DE LA ACCIÓN INTENTADA.

[96] Article 1 of Amparo Law (Ley de Amparo) published on the Federal Official Gazette on 10 January 1936, last amendment as of June 17, 2009.

[97] PÁRAMO FERNÁNDEZ, Marcelo. op. cit. p. 478.

acted as mediator in different procedures in 2004. The Commission issued guidelines in order to solve disputes of permittees.

The disputes concerned the measurement of natural gas at the point of receipt of the distribution systems; points of delivery of the national Pipeline System of Pemex-Gas and Basic Petrochemical and the measuring given by various distribution permittees.[98]

4. Brazil and Mexico: two realities

Brazil and Mexico are countries in Latin America; however, they speak different languages and have very different political histories.[99] They have in common the experience of extracting oil accompanied by a strong nationalism guard for the domain and property of oil. In addition, both countries share complex legal frameworks with very particular characteristics.

In the beginning, Brazil had a similar regulatory framework as Mexico does. Brazil in 1988 enacted a Constitution that stated the monopoly of the Union over the exploitation and prospecting of oil. Additionally, private participation in the exploitation of hydrocarbons and natural gas was forbidden by law. In 1995, private companies were allowed to perform exploitation and prospecting of oil. In Brazil, even private companies may be owners of oil once they have exploited and paid the corresponding taxes and royalties.

Since 1917, the Mexican Nation owns all the oil and all solid, liquid and gaseous hydrocarbons which may not be transferred to others. Therefore, Mexican State does not grant any concession contract. Mexico carries out the exploitation of the above through PEMEX.

Petrobras used to be an agent of the Brazilian Government. Now, depending on the area where the oil field be placed other companies may participate in the exploitation of oil.

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[98] The following permission holders underwent mediation procedures: Ecogas México, S. de R.L. de C.V., permission number G/013/DIS/97; Gas Natural México, S.A. de C.V., permission number G/015/DIS/97; Gas Natural México, S.A. de C.V., permission number G/018/DIS/97; Tamauligas, S.A. de C.V., permission number G/032/DIS/98; Comercializadora Metrogas, S.A. de C.V., permission number G/041/DIS/98; Consorcio Mexi-Gas, S.A. de C.V., permission number G/042/DIS/98; Tractebel DGJ, S.A. de C.V., permission number G/089/DIS/2000; Tractebel Digaqro, S.A. de C.V., permission number G/050/DIS/98; Ecogas México, S. de R.L. de C.V., permission number G/063/DIS/99; Gas Natural México, S.A. de C.V., permission number G/081/DIS/2000 Natgasmex, S.A. de C.V., permission number G/082/DIS/2000. José María Lujambio Irazábal op. cit.

[99] Goldstein, Andrea. The Emergence of Multilatinas: The Petrobras Experience. Universia Business Review, nº 25, 2010 Available at http://redalyc.uaemex.mx/src/inicio/ArtPdfRed.jsp?iCve=43312280006

The constitutionality of the current Brazilian oil legal framework was challenged. However, the Supreme Court declared the constitutionality of the law for oil exploration. The ruling distinguished between activity and property. Therefore, oil was still owned by the Union, but no more the economic activity of extraction.

The constitutionality of PEMEX Regulations was challenged. Nevertheless, the Mexican Supreme Court declared the conformity of PEMEX Regulations with the Constitution and PEMEX Law.

The financial situation of both countries and the need to develop *pre-sal* in Brazil and Mature fields of the south and north basins, Chicontepec and deepwater areas in Mexico obliged both countries to change the legal and economic framework of oil industry. In addition, regulations were influenced by political and economic factors.

As Petrobras is a mixed capital entity, entering into arbitration agreements seems not to be a great problem. Nevertheless, *pre-salt* area which is surrounded by many political issues and a very complex regulation involving the Union and other state entities is the exception. However, this exception may be justified.

PEMEX legal framework allows different ways of accepting and managing the risks of dispute resolution. As PEMEX is a state entity the regulation of arbitration and ADR is handled with careful detail. PEMEX regulations do not apply for gas disputes. Up to now it seems there is no precedent in Mexico of an arbitration procedure related to gas industry before the Energy Regulatory Commission.

Both countries accept arbitration and consider alternative means of dispute resolution of importance for business relations and granting security to investors.

With regard to exploration and extraction of oil, there seems to be little communication and mutual investment among PEMEX and Petrobras, in sharp contrast to the relation of Petrobras with other countries of South America.[100] Maybe the fact that PEMEX and Petrobras are both large companies, have put them away from the necessary and appropriate exchange of resources, technologies and opportunities.

Given this scenario of similarities and differences, the rule of law must be imposed over the circumstances and contingencies. The stability of the Constitutions and laws are the

[100] For instance, in Argentina, the Brazilian subsidiary has an important role. See FERREIRA, Pablo Gabriel. A Petrobrás e as reformas do setor de petróleo e gás no Brasil e na Argentina. *Rev. Sociol. Polit.* [online]. 2009, vol. 17, n. 33 [cited 2011-03-14], pp. 85-96. Available at <http://www.scielo.br/scielo.php?script=sci_arttext&pid=S010444782009000200007&lng=en&nrm=iso>. ISSN 0104-4478. doi: 10.1590/S0104-44782009000200007.

mainsprings for the efficient management of oil, the settlement of disputes and social development included the elimination of poverty, which is a common objective of both nations.