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2023

Latin America, a fertile land for energy arbitration

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Generated: March 7, 2024

Latin America, a fertile land for energy arbitration

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Summary

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In summary

Major investments have been realised in the past decades in the energy sector in Latin America, particularly in renewables. Further significant investments are expected in the coming years. Considering the traditional political instability in the region, with major swings that could result in drastic regulatory changes, investors are facing risks on their capital-intensive and long-term projects. The expected result of this combination of investments, political instability and regulatory changes would be a wave of both investment and commercial arbitration cases in the region. These claims would present some challenges on damages valuation.

Discussion points

- Investment in energy in Latin America
- Political instability is a risk to investors
- Regulatory changes follow policy changes and add risks for investors –Mexico case study
- Expected increase of arbitration cases in the energy sector
- Quantification of damages for energy arbitration presents challenges

Referenced in this article

- International Centre for Settlement of Investment Disputes
- Organización Latinoamericana de Energía
- Vicentin SAIC expropriation
- Chile's Draft Law Prohibiting the Installation and Operation of Coal-Fired Thermo-Electric Plants
- Mexico's Draft Decree Reforming Articles 25, 27 and 28 of the Mexican Constitution in Energy Matters
- Ecuador's Executive Decree 95

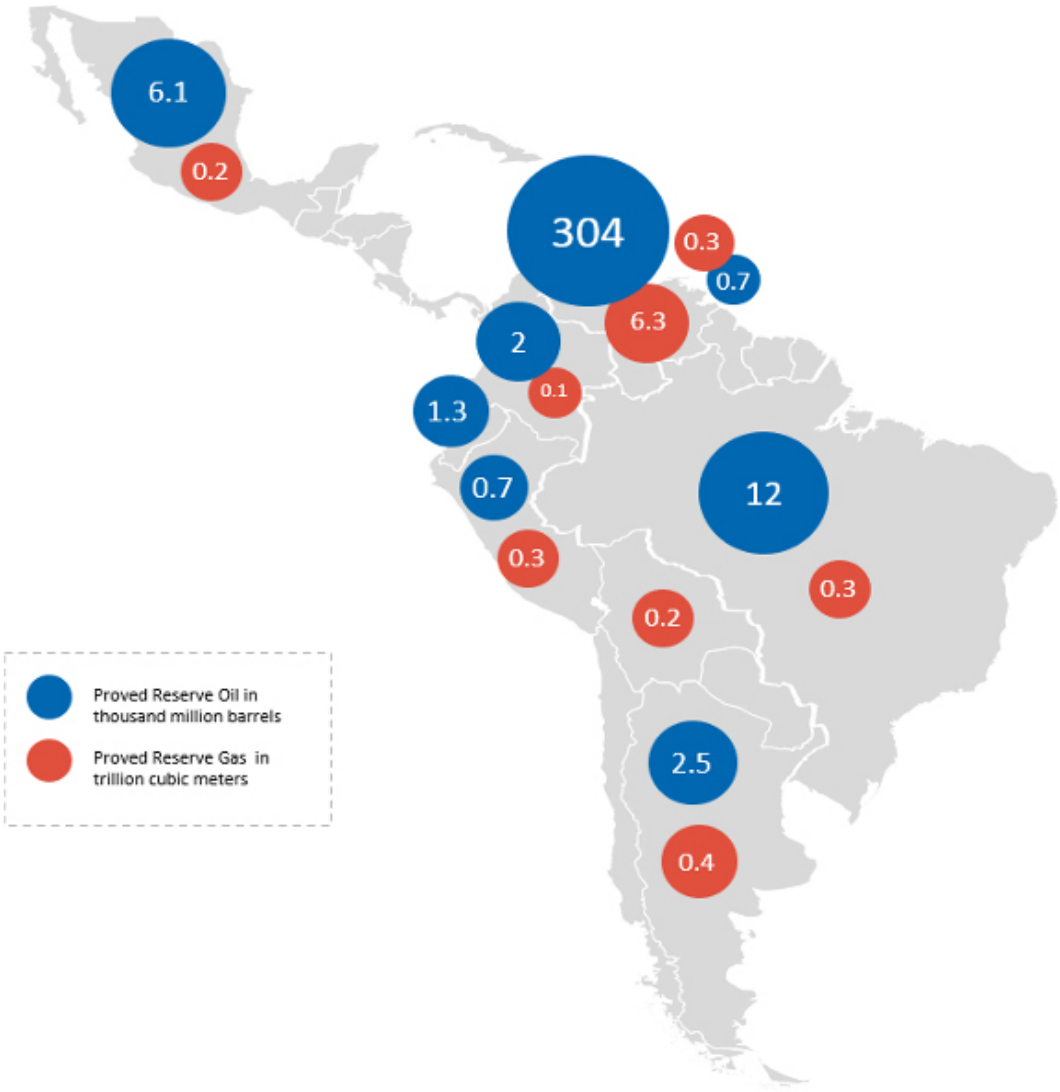
The importance of arbitration in Latin America has been continually increasing over the past decades. The energy sector – traditionally the source of a large number of arbitration cases worldwide – is expected to produce even more disputes in the coming years, based on the significant investments made in the sector (in particular in renewable energy), the global focus on energy transition and the instability of the political and regulatory landscapes in some parts of the region.

In this article, we first describe key aspects of the energy sector in Latin America. We then discuss the political and economic instability experienced in some parts of the region and the recent changes in regulation. We then comment on the expected proliferation of energy-related arbitration cases and the key challenges they bring in terms of valuation of damages.

Energy landscape

Latin America is home to large oil and gas reserves, with 19.1 per cent of global proven reserves located in the region, second only to the Middle East with 48.3 per cent. Most of these large reserves are located in Venezuela, which has the largest proven oil reserves and the ninth largest natural gas reserves in the world (see Figure 1).

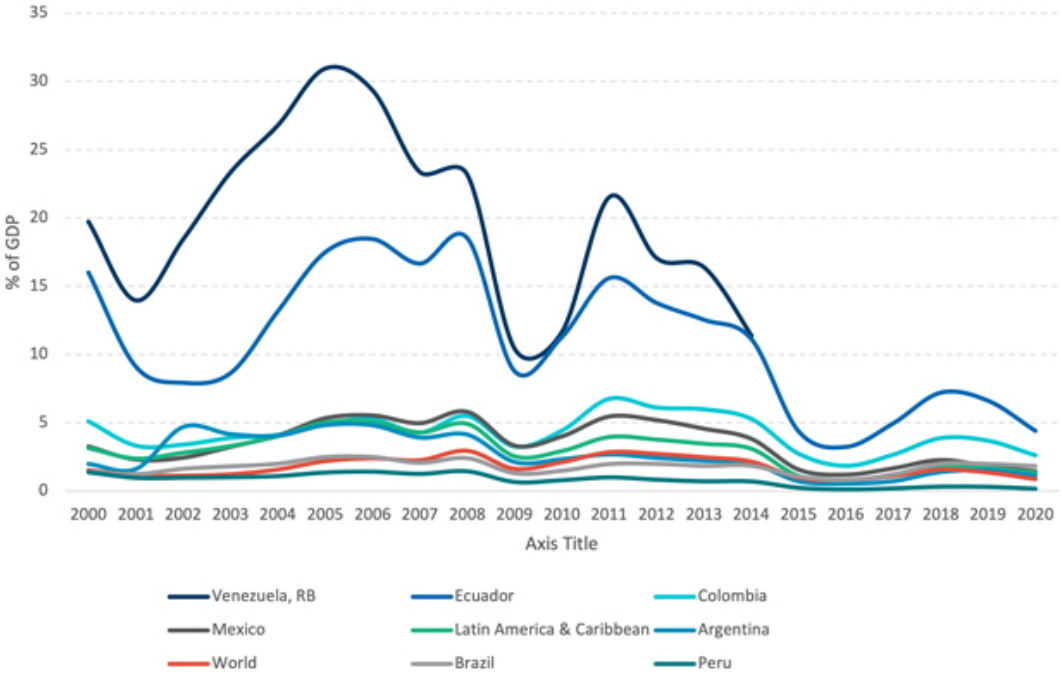
Figure 1: Proven reserves of oil and gas in Latin America in 2020



Sources: BP Statistical Review of World Energy 2021, FTI-Analysis

Oil has been a significant resource and a large contributor to the economy of producing countries in the region. Nevertheless, the change in oil rents[1] expressed as a percentage of GDP (see Figure 2) has narrowed in the last few years, compared with the large fluctuations seen between 2000 and 2014. It suggests that even for the largest producing countries in the region, namely Venezuela and Ecuador, the contribution of oil to GDP has significantly reduced over time.

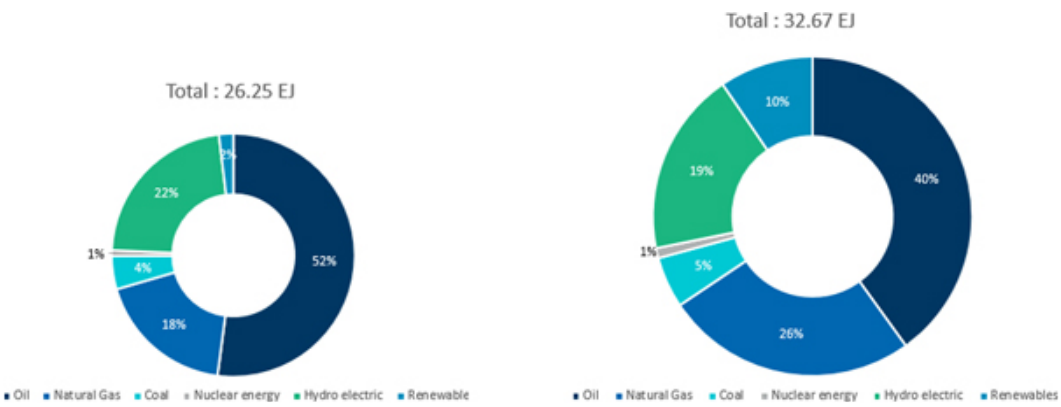
Figure 2: Oil rents expressed as percentage of GDP



Sources: World Bank, FTI-Analysis – Note: Values for Venezuela RB stop after 2014

Oil and gas have historically been the primary sources of energy in the region. Nevertheless, the share of electricity as a primary energy source increased steadily over the past 20 years thanks to the deployment of renewables. Renewable energy (excluding hydropower) represented 10 per cent of the total primary energy consumption in the region in 2020, increasing from 2 per cent in 2000 (see Figure 3). Interestingly, while hydropower has long been a key contributor to energy production in the region, its share of total primary energy decreased from 22 per cent in 2000 to 19 per cent in 2020, albeit within larger total consumption.[2]

Figure 3: Primary consumption by fuel in Latin America in 2000 and in 2020, in Exajoules (EJ)



Sources: BP, FTI-Analysis

The major increase in renewable capacity and production in Latin America comes from large investments in the technology from the early 2010s thanks to the incentive schemes put in place in some countries. Between 2010 and 2015, the total investment in renewables (mostly from foreign investors) exceeded US$80 billion, without accounting for large hydropower projects.[3] Significant investments have continued to be made since then. For example, in 2019 US$18.3 billion of additional renewable capacity representing 9.24 GW was added (mostly in Brazil, Chile and Mexico), representing a 43 per cent increase in investment in renewables compared with 2018. [4]

Economic development and projects were hit by the covid crisis in 2020. The economic impact of covid for Latin American economies has been particularly significant with 7 per cent GDP reduction, the largest in the world, more than twice the global GDP reduction of 3.3 per cent.[5] But, as demonstrated by the significant additional renewable capacity in 2021, there is an undeniable degree of economic recovery.

The covid crisis took a toll on the development and progress of many energy projects in both hydrocarbons and renewables. In Brazil, oil and gas licence bids were suspended by the national regulator,[6] and electricity auctions were cancelled.[7] Covid also affected ongoing business and operations as governments in the region took measures, like freezing energy prices or even suspending payment and collection of invoices that hurt utility companies.[8] Regulated entities such as transportation and distribution system operators also suffered as they saw a reduction of their revenues because of lower demand for electricity and gas.[9]

The energy landscape in Latin America, then, has experienced a dramatic change in the past 20 years, starting with the remarkable development of renewables which was facilitated by incentives offered to (mostly foreign) investors. The covid crisis hit the energy sector, but with the ongoing economic recovery, it is expected that new projects will be developed.[10] This economic recovery can be illustrated by the additional renewable capacity in 2021, which jumped to 16.97GW from 9.45GW in 2020.[11]

In such a dynamic and critical economic sector and in a volatile economic environment, investors in the region are exposed to market risks, but also to risks related to what is sometimes perceived as endemic instability of the local political and regulatory landscapes in some parts of the region.

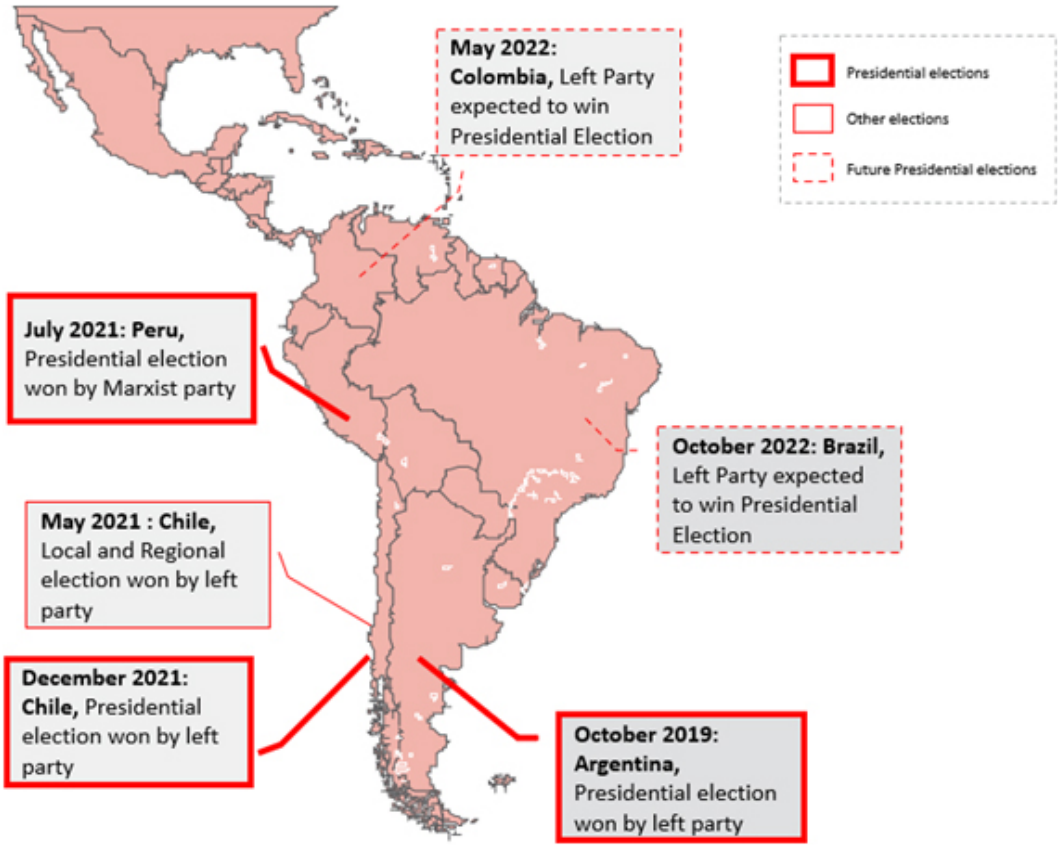
An unstable political landscape

The Latin American region is known for polarised political swings, creating a sense of instability that may make investors uncomfortable, or prompt them to require higher returns.

Since 2019, the political swing appears to be mainly going from the right to the left, from more economically liberal to left-leaning presidents and members of parliament. A similar broad change could be expected in countries with elections in 2022.[12] These recent swings appear to be driven in great part by a general dissatisfaction towards those in power, in particular towards the management of the covid crisis.

Figure 4 shows some of the recent and upcoming elections in the region in which power shifts to the left took place or are expected.

Figure 4: The rise of the left in Latin America



Sources: FTI-Analysis

The outcome of elections could affect the economic environment in which investors operate, generating risks they may not have expected or anticipated at the time of their original investments, for example:

- Argentina: In June 2020, a few months after his election in October 2019, President Fernández decided to expropriate crop trader Vicentin SAIC, raising concerns within the investors' community.[13] The investment community will heavily scrutinise the next presidential election due in 2023.
- Brazil: Former President Lula, promoting a left-wing agenda, is the front-runner for the presidential election in October 2022. Despite the possibilities of reversing many of the large privatisations of the past decades, investors continue to be interested in

investing in Brazil and remain confident that liberal economic policies would stay in place.[14] Should that not be the case, a wave of investment arbitration cases may well be triggered.

- Chile: The election of President Boric in December 2021 consolidated the political control of left-wing parties which some commentators consider could result in an unfavourable environment for foreign direct investment.
- Colombia: The country recently faced social protest and unrest, which paved the way for Gustavo Petro, a left-leaning candidate, who came first in the first round of the 2022 presidential election.[15] Some commentators believe that his election could affect the Colombian economy and the level of foreign direct investment.

This trend to the left is not uniform. For example, Ecuador is currently moving back to a more economically liberal policy favourable to investment, particularly from foreign investors. A new law was recently passed[16] under which they would be allowed to participate in the exploration and exploitation of its hydrocarbons reserves.[17]

Political change, particularly radical change, can have significant effects on foreign investments. They create uncertainty for investors about the legal and regulatory framework they will operate in. As a general principle, investors prefer stability and predictability – especially for capital-intensive and long-term projects, key characteristics of many energy projects.

Energy regulation evolution

For the energy sector, political change generally translates to regulatory change. Many countries across Latin America experienced a high number of regulatory reforms over the past decades, with some amendments required to accommodate the development of renewables. In more recent years, these seem to have increased in response to social unrest, climate change concerns and lately, to the covid crisis. In this section, we discuss the case of Mexico illustrating the multiple, major regulatory changes that could affect investor requirements and expectations.

Changes to the regulatory regime in Mexico started in 2019, soon after President López Obrador's election in December 2018, although the most significant and controversial decisions were taken in 2021.

Until 2019, Mexico had a power market in which incentive mechanisms were in place to attract foreign investments in generation and where the 'merit order' for production (the order in which the different power plants are dispatched) was purely based on marginal cost (with wind and solar coming first in the merit order thanks to their minimal marginal cost of production).

But, in March 2021, a bill amending the structure of the Mexican electricity market was passed.[18] This bill was designed to give the control of the national power market back to the state, through a state-owned entity. Among the many changes the Mexican government sought to implement, it proposed amending the rules for establishing the merit order of power production. This would no longer be based purely on costs; it would be primarily based on the identity of the owner of the generation plants, favouring primarily the state-owned CFE. The result would be to displace wind and solar production, mostly owned

by foreign investors, in favour of thermal generation. In other words, the Mexican government decision would lead to displacing clean and renewable production in favour of CO2 emitting hydrocarbon-fired power stations. It has been widely commented that should such a change be implemented, notwithstanding the negative impact on the environment and the fight against climate change, this would inevitably lead to multiple arbitration proceedings being triggered against Mexico by foreign investors.

The Mexican government promoted other changes to the electricity market in September 2021 that could have affected, among other things, existing power generation permits and power purchase agreements, with the introduction of a limit of 46 per cent of the national power demand to be met by privately owned power plants.

But these proposed changes were challenged in the courts. As a result, the President submitted a proposal[19] to Congress to modify the Constitution in October 2021 to promote its agenda to favour state-owned entities while avoiding legal challenges.[20] At the time of writing, the proposed changes to the regulation are still being fought in court. The eventual decision will be crucial in determining whether investors decide to move to arbitration proceedings.

The Mexican government proposal did not only intend to modify the electricity market rules and its functioning. It also attempted to change rules in the hydrocarbon sector to favour another national company, PEMEX, with the following measures:[21]

- suspension of exploration and production licensing rounds and revision of all hydrocarbon upstream contracts awarded to the private sector between 2015 and 2018;
- restriction on the ability of private companies to import and export hydrocarbons and limitation of new permits to five years not 20;[22] and
- national and energy security or security of the national economy to be grounds to annul or suspend hydrocarbon permits.[23]

Despite many of the government's proposals being put on hold by decisions in the Mexican courts, it is generally expected that Mexico would face multiple investment treaty claims if such measures come into force. This could trigger a wave of arbitration cases in Mexico and add multiple cases in a country (and a region) already involved in many arbitration proceedings.

Elsewhere in the region, changes in regulation and in the investment landscape were caused by the focus from some governments on energy transition. Although such changes are presented as necessary to meet the objectives of emission reduction in the fight against climate change, some investors would inevitably be adversely affected by such decisions and may seek compensation through arbitration processes.

For example, in Chile in early 2020, a draft law was submitted to the parliament to prevent the development of new coal-fired power plants and the operations of existing ones by 2025,-[24] in a similar way to measures taken in the Netherlands. If implemented, the closure of the remaining coal-fired power plants, initially scheduled for completion by 2040, would be drastically brought forward.[25] Such a reduction of the operational lifetime of the assets could materially affect the value for investors who may then make a claim.

As has happened in many European countries in recent years, changes in regulation in the energy sector could lead to multiple investment treaty cases. Changes in the economic, legal and regulatory environment lower the value of investments compared with the initial situation in which the investor operated and their initial expectations.

Energy arbitration cases expected to increase in Latin America

In terms of investment arbitration, Latin America provides more respondents in ICSID cases (30 per cent of all cases in 2021) than any other region. Coming back to the illustrative example of Mexico, it is already among the top 10 respondent countries in investor–state disputes. But as discussed above, Mexico may go even further up the ranking in the coming years on the back of arbitration in the energy sector if all the reforms proposed by the government are implemented.

Latin America is also a very active region for commercial arbitration. In 2020, there were 396 parties from Latin America and the Caribbean involved in ICC arbitration proceedings, representing approximately 15 per cent of the total. Brazil remained the most represented nationality within the region with 150 parties corresponding to 38 per cent of the total number of Latin American parties in 2020, rising to the second place in the worldwide ranking of nations.[26]

The number of ICSID and ICC cases in the region illustrates the importance of arbitration proceedings in Latin America and the reliance of investors and commercial parties on them to resolve their disputes.[27] General expectations are that the proportion of cases involving Latin American parties (including states) will continue to increase in the coming years, and particularly in the energy sector.

The growing number of arbitration cases in Latin America is due to a combination of structural factors favouring the use of arbitration:

- There are more than 600 bilateral investment treaties or investment agreements involving Latin American countries in which arbitration is, most of the time, the preferred dispute resolution mode.
- We observe a growing number of capital-intensive, long-term projects, not only in the energy sector, but also in mining and more generally in all economic sectors involving infrastructure.
- Some countries developed arbitration-friendly regimes, a crucial aspect for foreign investors when entering into significant long-term contracts with a state or state-owned entity (very relevant in the case of the energy sector). For example, Peru allows parties to choose their dispute resolution mode (including arbitration), while Mexico prescribes that disputes in hydrocarbon exploration and production are submitted to arbitration.
- The emergence of local arbitral institutions, which are advocating and promoting arbitration as an efficient dispute resolution mechanism and an alternative to the national court system, is also a structural movement in favour of international arbitration.

These factors, combined with the political and regulatory instability discussed earlier, are creating an environment in which more and more arbitration cases will likely appear, both commercial and investment arbitrations, in particular in the energy sector.

In terms of commercial arbitration, the cases to come could revolve around the 'classic' issues of construction delay, contractual default, non-performance or financing, among others. In addition to these, in light of the current inflation rate, additional arbitration cases might be triggered due to an economic environment putting some companies at risk. This riskier economic environment may also encourage investors to withdraw or to ask for a revision of their commercial terms. Likewise, this could encourage parties to seek revision of their commercial terms.

For investment arbitration, the experience of the wave of arbitration cases faced by some European countries after they amended their regulatory framework for incentives on renewables,[28] suggests that a comparable wave of arbitration cases could be anticipated in Latin America. Potential major regulatory changes to the energy sector are implemented either on the basis of economic necessity (to reduce incentives paid by the state) or environmental necessity (to reduce CO2 emissions).

The timing of these potential arbitration proceedings on renewable projects could arise earlier in the life cycle of the assets than in the European context. That would mean that the investors may consider their expectations to be frustrated earlier in the process than had been the case for investors in Europe, which could lead to larger damages claims, considering the longer duration of the frustrated investment, although much would depend on the specifics of each case.

Some arbitration matters may also be triggered ahead of any operation where permits or licences are denied to investors, before any energy production would materialise. In such cases, the investor may seek to claim for damages, either in the form of wasted costs or of lost profits.

The quantification of damages for energy arbitration

One of the main characteristics of contracts and investments in the energy sector is their long-term nature. If and when arbitration cases arise on these contracts or investments, the discounted cash flow (DCF) method is often considered the most appropriate method to value damages. The DCF method captures the future value of the contract or investment on a chosen date. The DCF method is the most widely used method in capital-intensive and long-term projects in the energy sector and in the mining and infrastructure sectors.

The damages calculated using DCF are the differences in the cash flow determined in the counterfactual scenario and the cash flow determined in the factual scenario discounted using a factor to reflect the time value of money and the relevant risks associated with the project or the investment.

The cash flow in both scenarios is primarily determined by four key parameters: the volumes of energy to be produced, purchased or sold, the prices for these volumes of energy, the costs of production, purchase or sale of these volumes and the applicable tax regime.

Arbitral tribunals have been divided on the application of the DCF method where assets have not yet entered into operation. The reluctance from some tribunals arises in part from

the absence of track records demonstrating that the assets would have been operated in a certain way or from the absence of sufficiently robust evidence that the investor could have delivered on the project as expected without the active or passive interference of the state. Some tribunals consider that the approach is too speculative in the circumstances and consider that the volumes of energy on which the damages are calculated to be too uncertain.

Nevertheless, differences in approach by arbitral tribunals could appear depending on the nature of the asset: for an oil and gas production asset, documented and evidenced proven reserves could be considered as sufficiently robust evidence to use a DCF approach in their valuation. For instance, in an oil and gas project, if reserves are deemed economic and expected to be produced, they will most likely be produced and be able to be sold given the market liquidity for these products. For renewables, the arbitral tribunals may be more reluctant to use expected production figures, as these might be perceived as more uncertain, especially in regions where no other comparable projects could be used as a benchmark for effective production. This could be the case for renewable projects developed in new areas where no existing installations are in operation.

The discount factor is another key component of the DCF method ,as its variation could significantly affect damages valuation. It is consequently extensively debated between damages experts as the discount factor is where the risk and uncertainty of the project, in particular the country risk, are integrated and valued. The determination of the appropriate discount factor in a political, regulatory and economic environment considered as less stable, such as Latin America, can be more challenging.

The DCF is not the only method that could be used to value damages in the energy sector. A market approach could well be envisaged, but it would only prove effective and persuasive if comparable companies or projects in the region exist to derive the valuation of damages. Comparable data may be available for other regions in the world, but assumptions and adjustments would be needed for these to be applicable to a very different regional context.

In any case, before being able to claim damages, the claimant will likely first need to establish the causal link between the claimed breach or change and the impact on the project's operations.

In arbitration cases that could be triggered further to a change of regulation as discussed above, the direct connection between the change in regulation and the impact on operations of the project needs to be established to be in a position for the investor to make a claim. The change of regulation/law should be the only difference between the factual and counterfactual scenarios at the starting point of the latter scenario. Although there should be a single difference in the starting point of both scenarios, multiple differences may then appear on the various key parameters for the calculation of the cash flows in both scenarios since the change of law or regulation may affect the entire project.

Conclusion

The number of arbitration cases in the energy sector in Latin America is expected to grow resulting from the combination of major investments (mostly foreign), some instability and uncertainty in politics and in regulation in parts of the region and some arbitration-friendly legislative frameworks. With the global focus on energy transition and climate change, in

addition to these cases, more arbitration cases should arise in relation to environmental issues or climate change issues. Latin America has been at the forefront of climate change claims, for example in the case of Saúl Luciano Lliuya, a Peruvian farmer who filed a lawsuit against the German energy company RWE which claims that the company knowingly contributed to climate change by emitting greenhouse gases by producing electricity from coal. The region could well be a driving force on climate change arbitration.

The views expressed in this article are the authors' alone.

Footnotes

[1] The World Bank defines 'oil rent' as the difference between the value of crude oil production at regional prices and total costs of production.

[2] World Bank, Electricity production from hydroelectric sources (% of total) – Latin America & Caribbean (https://data.worldbank.org/indicator/EG.ELC.HYRO.ZS?locations=ZJ).

[3] IRENA, 'Renewable Energy Statistics 2016: Latin America and the Caribbean', 2016.

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[6] Reuters, 'Brazil's ANP suspends oil, gas bidding rounds due to coronavirus', April 2020.

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[8] Organización Latinoamericana de Energía, 'How is the Energy Sector in Latin America and The Caribbean acting to Face the Covid-19 Pandemic?', 2020.

[9] Organización Latinoamericana de Energía, 'Análisis de los impactos de la pandemia del COVID-19 sobre el Sector Energético de América Latina y el Caribe', 2021.

[10] Rated Power, 'Renewable energy in Latin America: 5 renewable energy trends emerging from south of Rio Grande', April 2021.

[11] https://www.irena.org/Statistics/View-Data-by-Topic/Capacity-and-Generation/Regional-Trends.

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[13] https://www.globaltradealert.org/intervention/82679/fdi-treatment-and-operations-nes/argentina-temporary-expropriation-of-an-american-cereal-company.

[14] Reuters, 'Bankers brush off concerns about Brazil's polarized election', 17 May 2022.

[15] https://www.theguardian.com/world/2022/may/30/colombia-presidential-election-leftist-former-guerilla-and-populist-outsider-head-to-runoff.

[16] Executive Decree 95, 7 July 2021.

[17] 'Ecuador president issues decree to open Petroecuador to private investors', S&P Global Commodity Insights, July 2021.

[18] Decree Reforming and Adding Various Provisions of the Law of Industrial Electricity, 9 March 2021.

[19] Mexico Draft Decree Reforming Articles 25, 27 and 28 of the Mexican Constitution in Energy Matters, 1 October 2021.

[20] Gobierno de México Prensa, 'Comunicado: Reforma constitucional en materia eléctrica es conveniente para el pueblo, afirma presidente', 11 October 2021.

[21] Raúl Gutiérrez-Meave, Juan Rosellón and Luis Sarmiento, 'The Effect of Changing Marginal-Cost to Physical Order Dispatch in the Power Sector', 2021.

[22] December 2020, the new Hydrocarbon and Fuel Import and Export Rules issued by the Ministry of Energy.

[23] Global Finance magazine, 'Mexico At A Crossroads', October 2021.

[24] Draft Law Prohibiting the Installation and Operation of Coal-Fired Thermo-Electric Plants.

[25] Chile Senate, '¿Es posible terminar con las centrales termoeléctricas a carbón al 2025?', November 2021.

[26] ICC, ICC Dispute Resolution 2020 Statistics, 2021.

[27] ICSID, The ICSID Caseload Statistics, 2022.

[28] Spain currently holds the record with more than 50 arbitration cases on renewables.

IN SUMMARY

Major investments have been realised in the past decades in the energy sector in Latin America, particularly in renewables. Further significant investments are expected in the coming years. Considering the traditional political instability in the region, with major swings that could result in drastic regulatory changes, investors are facing risks on their capital-intensive and long-term projects. The expected result of this combination of investments, political instability and regulatory changes would be a wave of both investment and commercial arbitration cases in the region. These claims would present some challenges on damages valuation.

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The importance of arbitration in Latin America has been continually increasing over the past decades. The energy sector – traditionally the source of a large number of arbitration cases worldwide – is expected to produce even more disputes in the coming years, based on the significant investments made in the sector (in particular in renewable energy), the global focus on energy transition and the instability of the political and regulatory landscapes in some parts of the region.

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ENERGY LANDSCAPE

Latin America is home to large oil and gas reserves, with 19.1 per cent of global proven reserves located in the region, second only to the Middle East with 48.3 per cent. Most of these large reserves are located in Venezuela, which has the largest proven oil reserves and the ninth largest natural gas reserves in the world (see Figure 1).

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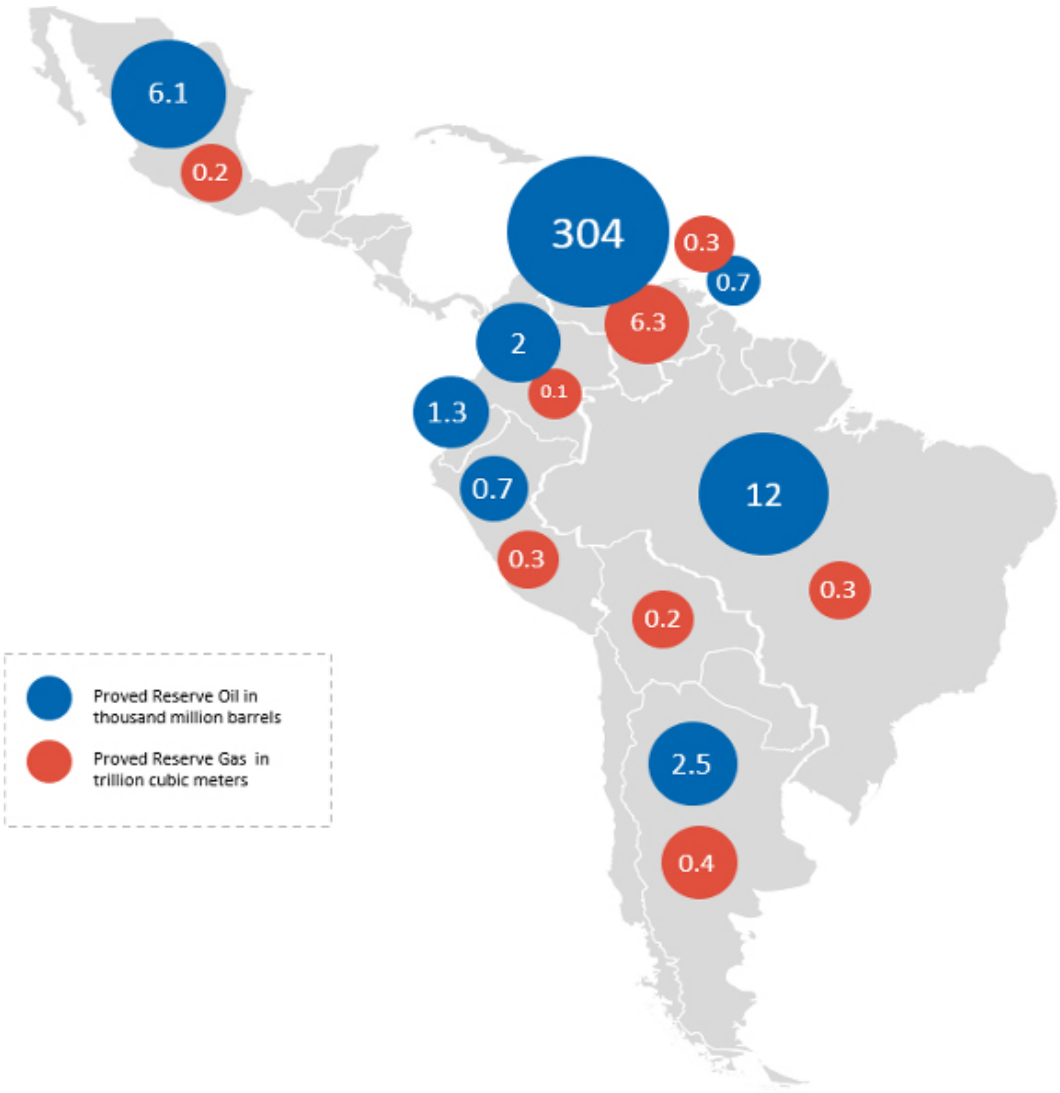

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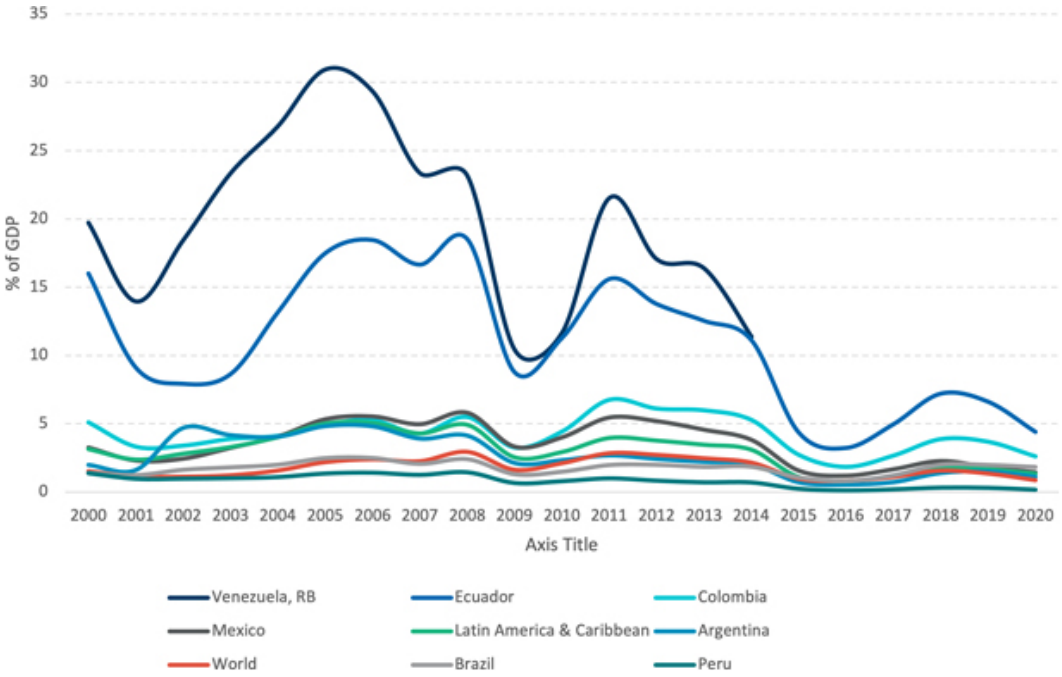
Figure 2: Oil Rents Expressed As Percentage Of GDP



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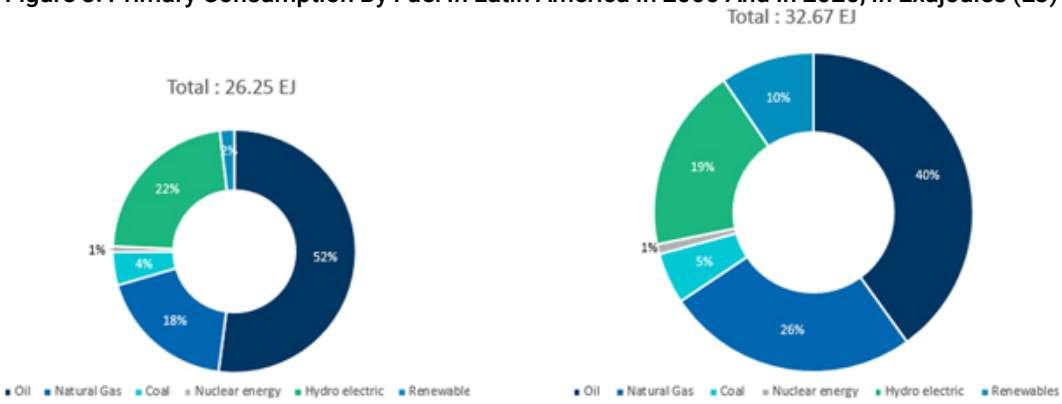

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AN UNSTABLE POLITICAL LANDSCAPE

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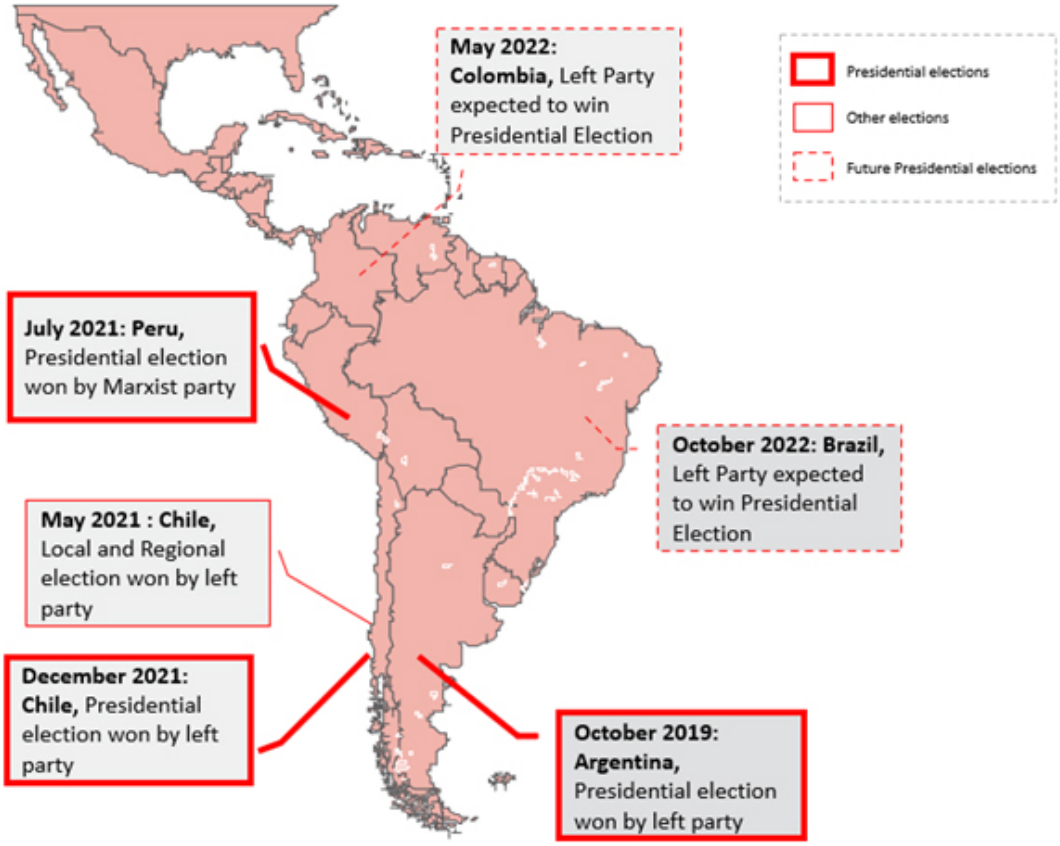

Sources: FTI-Analysis

ENERGY REGULATION EVOLUTION

For the energy sector, political change generally translates to regulatory change. Many countries across Latin America experienced a high number of regulatory reforms over the past decades, with some amendments required to accommodate the development of renewables. In more recent years, these seem to have increased in response to social unrest, climate change concerns and lately, to the covid crisis. In this section, we discuss the case of Mexico illustrating the multiple, major regulatory changes that could affect investor requirements and expectations.

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But, in March 2021, a bill amending the structure of the Mexican electricity market was passed.[18] This bill was designed to give the control of the national power market back to the state, through a state-owned entity. Among the many changes the Mexican government sought to implement, it proposed amending the rules for establishing the merit order of power production. This would no longer be based purely on costs; it would be primarily based on the identity of the owner of the generation plants, favouring primarily the

state-owned CFE. The result would be to displace wind and solar production, mostly owned by foreign investors, in favour of thermal generation. In other words, the Mexican government decision would lead to displacing clean and renewable production in favour of CO2 emitting hydrocarbon-fired power stations. It has been widely commented that should such a change be implemented, notwithstanding the negative impact on the environment and the fight against climate change, this would inevitably lead to multiple arbitration proceedings being triggered against Mexico by foreign investors.

The Mexican government promoted other changes to the electricity market in September 2021 that could have affected, among other things, existing power generation permits and power purchase agreements, with the introduction of a limit of 46 per cent of the national power demand to be met by privately owned power plants.

But these proposed changes were challenged in the courts. As a result, the President submitted a proposal[19] to Congress to modify the Constitution in October 2021 to promote its agenda to favour state-owned entities while avoiding legal challenges.[20] At the time of writing, the proposed changes to the regulation are still being fought in court. The eventual decision will be crucial in determining whether investors decide to move to arbitration proceedings.

The Mexican government proposal did not only intend to modify the electricity market rules and its functioning. It also attempted to change rules in the hydrocarbon sector to favour another national company, PEMEX, with the following measures:[21]

- suspension of exploration and production licensing rounds and revision of all hydrocarbon upstream contracts awarded to the private sector between 2015 and 2018;
- restriction on the ability of private companies to import and export hydrocarbons and limitation of new permits to five years not 20;[22] and
- national and energy security or security of the national economy to be grounds to annul or suspend hydrocarbon permits.[23]

Despite many of the government's proposals being put on hold by decisions in the Mexican courts, it is generally expected that Mexico would face multiple investment treaty claims if such measures come into force. This could trigger a wave of arbitration cases in Mexico and add multiple cases in a country (and a region) already involved in many arbitration proceedings.

Elsewhere in the region, changes in regulation and in the investment landscape were caused by the focus from some governments on energy transition. Although such changes are presented as necessary to meet the objectives of emission reduction in the fight against climate change, some investors would inevitably be adversely affected by such decisions and may seek compensation through arbitration processes.

For example, in Chile in early 2020, a draft law was submitted to the parliament to prevent the development of new coal-fired power plants and the operations of existing ones by 2025,-[24] in a similar way to measures taken in the Netherlands. If implemented, the closure of the remaining coal-fired power plants, initially scheduled for completion by 2040, would be drastically brought forward.[25] Such a reduction of the operational lifetime of the assets could materially affect the value for investors who may then make a claim.

As has happened in many European countries in recent years, changes in regulation in the energy sector could lead to multiple investment treaty cases. Changes in the economic, legal and regulatory environment lower the value of investments compared with the initial situation in which the investor operated and their initial expectations.

ENERGY ARBITRATION CASES EXPECTED TO INCREASE IN LATIN AMERICA

In terms of investment arbitration, Latin America provides more respondents in ICSID cases (30 per cent of all cases in 2021) than any other region. Coming back to the illustrative example of Mexico, it is already among the top 10 respondent countries in investor–state disputes. But as discussed above, Mexico may go even further up the ranking in the coming years on the back of arbitration in the energy sector if all the reforms proposed by the government are implemented.

Latin America is also a very active region for commercial arbitration. In 2020, there were 396 parties from Latin America and the Caribbean involved in ICC arbitration proceedings, representing approximately 15 per cent of the total. Brazil remained the most represented nationality within the region with 150 parties corresponding to 38 per cent of the total number of Latin American parties in 2020, rising to the second place in the worldwide ranking of nations.[26]

The number of ICSID and ICC cases in the region illustrates the importance of arbitration proceedings in Latin America and the reliance of investors and commercial parties on them to resolve their disputes.[27] General expectations are that the proportion of cases involving Latin American parties (including states) will continue to increase in the coming years, and particularly in the energy sector.

The growing number of arbitration cases in Latin America is due to a combination of structural factors favouring the use of arbitration:

- There are more than 600 bilateral investment treaties or investment agreements involving Latin American countries in which arbitration is, most of the time, the preferred dispute resolution mode.
- We observe a growing number of capital-intensive, long-term projects, not only in the energy sector, but also in mining and more generally in all economic sectors involving infrastructure.
- Some countries developed arbitration-friendly regimes, a crucial aspect for foreign investors when entering into significant long-term contracts with a state or state-owned entity (very relevant in the case of the energy sector). For example, Peru allows parties to choose their dispute resolution mode (including arbitration), while Mexico prescribes that disputes in hydrocarbon exploration and production are submitted to arbitration.
- The emergence of local arbitral institutions, which are advocating and promoting arbitration as an efficient dispute resolution mechanism and an alternative to the national court system, is also a structural movement in favour of international arbitration.

These factors, combined with the political and regulatory instability discussed earlier, are creating an environment in which more and more arbitration cases will likely appear, both commercial and investment arbitrations, in particular in the energy sector.

In terms of commercial arbitration, the cases to come could revolve around the 'classic' issues of construction delay, contractual default, non-performance or financing, among others. In addition to these, in light of the current inflation rate, additional arbitration cases might be triggered due to an economic environment putting some companies at risk. This riskier economic environment may also encourage investors to withdraw or to ask for a revision of their commercial terms. Likewise, this could encourage parties to seek revision of their commercial terms.

For investment arbitration, the experience of the wave of arbitration cases faced by some European countries after they amended their regulatory framework for incentives on renewables,[28] suggests that a comparable wave of arbitration cases could be anticipated in Latin America. Potential major regulatory changes to the energy sector are implemented either on the basis of economic necessity (to reduce incentives paid by the state) or environmental necessity (to reduce CO2 emissions).

The timing of these potential arbitration proceedings on renewable projects could arise earlier in the life cycle of the assets than in the European context. That would mean that the investors may consider their expectations to be frustrated earlier in the process than had been the case for investors in Europe, which could lead to larger damages claims, considering the longer duration of the frustrated investment, although much would depend on the specifics of each case.

Some arbitration matters may also be triggered ahead of any operation where permits or licences are denied to investors, before any energy production would materialise. In such cases, the investor may seek to claim for damages, either in the form of wasted costs or of lost profits.

THE QUANTIFICATION OF DAMAGES FOR ENERGY ARBITRATION

One of the main characteristics of contracts and investments in the energy sector is their long-term nature. If and when arbitration cases arise on these contracts or investments, the discounted cash flow (DCF) method is often considered the most appropriate method to value damages. The DCF method captures the future value of the contract or investment on a chosen date. The DCF method is the most widely used method in capital-intensive and long-term projects in the energy sector and in the mining and infrastructure sectors.

The damages calculated using DCF are the differences in the cash flow determined in the counterfactual scenario and the cash flow determined in the factual scenario discounted using a factor to reflect the time value of money and the relevant risks associated with the project or the investment.

The cash flow in both scenarios is primarily determined by four key parameters: the volumes of energy to be produced, purchased or sold, the prices for these volumes of energy, the costs of production, purchase or sale of these volumes and the applicable tax regime.

Arbitral tribunals have been divided on the application of the DCF method where assets have not yet entered into operation. The reluctance from some tribunals arises in part from the absence of track records demonstrating that the assets would have been operated in a certain way or from the absence of sufficiently robust evidence that the investor could have delivered on the project as expected without the active or passive interference of the state. Some tribunals consider that the approach is too speculative in the circumstances

and consider that the volumes of energy on which the damages are calculated to be too uncertain.

Nevertheless, differences in approach by arbitral tribunals could appear depending on the nature of the asset: for an oil and gas production asset, documented and evidenced proven reserves could be considered as sufficiently robust evidence to use a DCF approach in their valuation. For instance, in an oil and gas project, if reserves are deemed economic and expected to be produced, they will most likely be produced and be able to be sold given the market liquidity for these products. For renewables, the arbitral tribunals may be more reluctant to use expected production figures, as these might be perceived as more uncertain, especially in regions where no other comparable projects could be used as a benchmark for effective production. This could be the case for renewable projects developed in new areas where no existing installations are in operation.

The discount factor is another key component of the DCF method ,as its variation could significantly affect damages valuation. It is consequently extensively debated between damages experts as the discount factor is where the risk and uncertainty of the project, in particular the country risk, are integrated and valued. The determination of the appropriate discount factor in a political, regulatory and economic environment considered as less stable, such as Latin America, can be more challenging.

The DCF is not the only method that could be used to value damages in the energy sector. A market approach could well be envisaged, but it would only prove effective and persuasive if comparable companies or projects in the region exist to derive the valuation of damages. Comparable data may be available for other regions in the world, but assumptions and adjustments would be needed for these to be applicable to a very different regional context.

In any case, before being able to claim damages, the claimant will likely first need to establish the causal link between the claimed breach or change and the impact on the project's operations.

In arbitration cases that could be triggered further to a change of regulation as discussed above, the direct connection between the change in regulation and the impact on operations of the project needs to be established to be in a position for the investor to make a claim. The change of regulation/law should be the only difference between the factual and counterfactual scenarios at the starting point of the latter scenario. Although there should be a single difference in the starting point of both scenarios, multiple differences may then appear on the various key parameters for the calculation of the cash flows in both scenarios since the change of law or regulation may affect the entire project.

CONCLUSION

The number of arbitration cases in the energy sector in Latin America is expected to grow resulting from the combination of major investments (mostly foreign), some instability and uncertainty in politics and in regulation in parts of the region and some arbitration-friendly legislative frameworks. With the global focus on energy transition and climate change, in addition to these cases, more arbitration cases should arise in relation to environmental issues or climate change issues. Latin America has been at the forefront of climate change claims, for example in the case of Saúl Luciano Lliuya, a Peruvian farmer who filed a lawsuit against the German energy company RWE which claims that the company knowingly contributed to climate change by emitting greenhouse gases by producing electricity from coal. The region could well be a driving force on climate change arbitration.

The views expressed in this article are the authors' alone.

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