IN THE ARBITRATION UNDER CHAPTER 11
OF THE NORTH AMERICAN FREE TRADE AGREEMENT
AND THE UNCITRAL ARBITRATION RULES
BETWEEN

METHANEX CORPORATION,

Claimant/Investor,

-and-

UNITED STATES OF AMERICA,

Respondent/Party.

STATEMENT OF DEFENSE OF RESPONDENT UNITED STATES OF AMERICA

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In accordance with the Tribunal's First Procedural Order and as contemplated by Article 19 of the UNCITRAL Arbitration Rules, Respondent United States of America respectfully submits the following Statement of Defense to the claim of Methanex Corporation ("Methanex") pursuant to Chapter 11 of the North American Free Trade Agreement (the "NAFTA").

I. PRELIMINARY STATEMENT

1. There is no merit to Methanex's claim that the NAFTA was violated by the California legislature's authorization of funding for a university study of the public health and environmental effects of methyl tertiary butyl ether ("MTBE") and the California Governor's subsequent

executive order calling for certain state agencies to take preliminary steps toward a phase-out of the use of MTBE in California gasoline.

2. Methanex's claim does not remotely resemble the type of grievance for which the States Parties to the NAFTA created the investor-State dispute resolution mechanism of Chapter 11. Methanex's case is founded on the proposition that, whenever a State takes action to protect the public health or environment, the State is responsible for damages to every business enterprise claiming a resultant setback in its fortunes if the enterprise can persuade an arbitral tribunal that the action could have been handled differently. Plainly put, this proposition is absurd. If accepted by this Tribunal, no NAFTA Party could carry out its most fundamental governmental functions unless it were prepared to pay for each and every economic impact occasioned by doing so. The NAFTA Parties never intended the NAFTA to bring about such a radical change in the way that they function, and Methanex cannot show otherwise.

3. The Tribunal should reject Methanex's novel attempt to obtain compensation for public-health measures concerning a product that Methanex does not even manufacture. Methanex may be disappointed that California decided to protect its drinking water supply through the means it chose rather than those Methanex advocated. But the "NAFTA was not intended to provide foreign investors with blanket protection from this kind of disappointment, and nothing in its terms so provides."[1]

4. As demonstrated below, Methanex's claims are not within the jurisdiction of this Tribunal and lack legal and factual merit.

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[1] *Azinian v. United Mexican States*, ICSID Case No. ARB(AF)/97/2, 14 Foreign Inv. L.J. 538, 562 ¶ 83 (1999) (Nov. 1, 1999) (Award).

Jurisdiction And Admissibility

5. Methanex's claims are not within the jurisdiction of this Tribunal for several reasons. *First*, Methanex grossly mischaracterizes the California measures at issue in suggesting that they ban MTBE. California Senate Bill 521 (the "Bill") merely authorized state funding for a university study of MTBE. Executive Order No. D-5-99 (the "Executive Order") directed California agencies to take certain steps toward issuing final and effective regulations concerning the use of MTBE in gasoline. No final regulation banning MTBE in gasoline, however, is in effect. The California actions at issue are not measures "relating to" Methanex or its investments. Methanex's claims are therefore not within the scope of Chapter 11 as defined by NAFTA Article 1101(1).

6. *Second,* Methanex is far too removed from the California actions at issue to invoke the jurisdiction of this Tribunal. Methanex manufactures and markets methanol, not MTBE. A future ban of MTBE in California's gasoline will impact Methanex only indirectly, as a result of a decreased desire on the part of MTBE manufacturers directly affected by a ban to buy methanol from Methanex. Under fundamental principles of customary international law, Methanex lacks standing because any injury would result solely from these measures' potential effect on Methanex's prospective contractual counterparties.

7. *Third,* the injuries claimed by Methanex – to the extent they are cognizable at all – are derivative of injuries allegedly suffered by Methanex's subsidiaries. Article 1116 of the NAFTA provides no jurisdiction over claims by a shareholder in its own right for alleged injuries to an enterprise. Moreover, Methanex cannot demonstrate that it has suffered a loss "by reason of, or arising out of" California's actions as required by Article 1116.

8. *Fourth*, Methanex has failed to present a valid waiver of its subsidiaries' municipal remedies – a formal requirement for this Tribunal to be seized of jurisdiction.

9. *Fifth*, Methanex's claim under Article 1110 fails to identify any expropriated "investment" within Chapter 11's definition of that term.

10. *Finally*, Methanex's claim under Article 1105(1) is inadmissible because no customary international legal standard governs the *process* by which States make legislative or executive decisions. Because the actions at issue also implicate no substantive customary international legal standards, Methanex's 1105(1) claim is inadmissible.

Liability

11. Methanex's claims also fail on the merits. *First*, the measures at issue here in no sense can be viewed as an expropriation within the meaning of Article 1110. Methanex still owns and fully controls both of its enterprises in the United States. Methanex closed its Fortier plant before the issuance of the Executive Order for reasons that had nothing to do with any proposed ban of MTBE in California's gasoline. That plant never supplied California customers in any event. In addition, most methanol is sold for uses other than MTBE. Methanex's marketing subsidiary continues to be able to sell methanol anywhere it wishes in the United States – including California – to anyone who wishes to make a purchase. A ban on MTBE in California's gasoline might ultimately reduce the desire of some MTBE producers for methanol, but neither municipal nor international law recognizes any property right to the continued demand for a product by a given set of clientele.

12. Moreover, the California actions are nondiscriminatory environmental measures to protect public health by safeguarding the public's drinking water supply. Measures such as

these can only in extraordinary circumstances be found to constitute a compensable expropriation. No such circumstances are present here.

13. *Second*, Methanex's claims under Article 1105(1) lack merit under any standard. The Executive Order was issued after several days of public comment and testimony. It is amply supported by scientific findings. Methanex's allegations are indistinguishable from those of any disgruntled party who disagrees with one portion of a comprehensive governmental action. They fall far short of the exceptional circumstances required to justify the intervention of an international tribunal under Article 1105(1).

Damages

14. Methanex's damages claims, based largely on the decline in its share price, are without factual or legal support. Contrary to Methanex's suggestion, the financial markets did not react to the announcement of either the Bill or the Executive Order. The long decline in Methanex's share price – which, ironically, has reversed since the announcement of the California measures – began in 1995 and reflected Methanex's status as producer of a single commodity chemical in an industry plagued by production capacity that exceeded demand. That decline did not result from the California measures at issue here. Indeed, the global price of methanol – and Methanex's fortunes along with it – has substantially *improved* since the announcement of the Executive Order. Methanex's other claims of loss are similarly without support.

II. FACTS

A. The Nature of Methanex's Business

1. The Methanol Market

15. Methanex produces and markets methanol. Produced principally from natural gas, methanol is one of the world's largest-volume commodity chemicals. Methanol is primarily used to produce formaldehyde, acetic acid and other chemical derivatives. These products in turn are used to produce a wide variety of finished products, including many forms of modern clothing and fabrics, plastic bottles and laminated wood products.

16. The market for methanol is global and highly competitive. Like that for many commodity chemicals, the market for methanol is characterized by cycles of oversupply resulting in lower prices and idled capacity, followed by periods of shortage and rising prices as demand catches up and exceeds supply until increased prices justify new plant investment.

17. The methanol market has been characterized in recent years by overcapacity. Methanol prices dropped from highs exceeding $500 per ton in 1995 to less than $200 per ton in 1996. Prices remained below $250 per ton for the remainder of the decade. Several large, new plants opened in 1999 and more are expected to go into production in the years 2000 through 2002. Although the demand for methanol derivatives grew from 1998 to 1999, the increase in demand was insufficient to offset the excess supply.

18. A consequence of this low-price environment was that older, higher-cost methanol plants in developed countries were increasingly closed in favor of lower-cost facilities in developing countries.

19. Methanol is principally transported by sea. Transportation cost is a significant factor in methanol sales. Methanol produced at higher-cost facilities in developed countries is generally sold to nearby local markets. Methanol produced at lower-cost facilities in developing countries can competitively be shipped to markets in developed countries.

2. Methanex

20. Methanex is the world's largest producer and marketer of methanol. Its corporate headquarters are in Vancouver, British Columbia, Canada.

21. In recent years, Methanex has followed a strategy of closing or selling its higher-cost production facilities in North America in favor of its lower-cost facilities in South America and the Southern Pacific. Methanex's production activities are now overwhelmingly concentrated outside of North America.

22. As of 1998, 75 percent of Methanex's production capacity was already located in Chile and New Zealand. The remainder of Methanex's production capacity at that time derived from four North American plants: one on the Pacific coast in Kitimat, British Columbia; one on the Gulf of Mexico coast in Fortier, Louisiana; and two in Medicine Hat, Alberta.

23. In 1998, the Kitimat plant shipped methanol to customers in California, the Pacific Northwest and Asia. The Fortier plant serviced customers in the southeastern United States and along the Mississippi River. The Medicine Hat plants supplied customers in the Midwestern Canadian and United States markets.

24. In the Spring of 1999, Methanex opened a new methanol plant at its facility in Chile, which already housed two other methanol plants. The new plant is the largest in what is now Methanex's largest and lowest-cost facility.

25. At the same time, Methanex began a program of closing down higher-cost facilities. As of March 1, 1999, Methanex closed the Fortier plant indefinitely. It remains idled. In the week of March 15, 1999, Methanex permanently closed one of its two plants in Medicine Hat. In June 1999, Methanex announced the sale of its Kitimat plant for $1 and other consideration. In July 2000, Methanex announced the closure of the Kitimat plant.

26. It appears that Methanex now exclusively supplies the California market with methanol that it has either produced in Chile or New Zealand or purchased from other producers of methanol.

27. Methanex's profitability and its stock price in recent years have reflected its status as a producer of a single commodity chemical in an industry characterized by overcapacity. Until recently, its profitability and stock price have slowly and steadily declined, and market interest in Methanex shares has dwindled.

28. In 1994, Methanex reported net income per share of $2.20. Its average share price was $12.70 and over 266 million of its shares traded on the NASDAQ exchange. By contrast, in 1999 it reported a second consecutive annual loss ($0.47 per share in 1999); its average share price was $3.37; and fewer than 10 million of its shares traded on the NASDAQ.

29. Trading in Methanex shares during the weeks of the announcements of the issuance of the Bill and the Executive Order was consistent with longer-term trends. It in no way suggested

the sudden spike in volume and dramatic change in share price that mark a material market reaction to an external event.

30. The week before the announcement of the Bill, Methanex's shares closed on the NASDAQ exchange at $8 7/8. The Governor approved the Bill after the close of the markets on October 8, 1997. The closing price for Methanex's shares that day was $8 3/4. The following day, Methanex's shares closed *up* 13 cents at $8 7/8, with 203,000 shares traded. That trading volume was *less* than the average daily volume of 233,600 shares for that week.

31. The week of the announcement of the Executive Order, Methanex shares opened on the NASDAQ exchange at $3 9/16. The Executive Order was announced after the close of the markets on March 25, 1999. The following day, Methanex shares opened at $3 9/16 and then closed down 19 cents at $3 3/8, with 23,200 shares traded. That trading volume was *less* than the average daily volume of 26,100 shares for the week.

32. Methanex's fortunes have gradually improved since the announcement of the Executive Order. In 1999, Methanex's net losses per share improved from $0.23 in the first quarter, to $0.13 in the second quarter, to $0.06 in the third quarter and to $0.05 in the fourth quarter. Methanex's sales volume increased by 10 percent in 1999 compared to 1998. Fueled by strong demand and rising prices for methanol in all markets – including that for MTBE – Methanex reported net *income* of $0.11 per share and record production and sales of methanol for the first half of 2000. Its share price increased by over 75 percent in April and May 2000. In August 2000, Methanex's shares closed on the NASDAQ at levels approaching $5 per

share – higher than the closing prices in March 1999 before the announcement of the Executive Order.

3. Methanex's US Investments

33. Methanex alleges that it indirectly owns two investments in the United States: Methanex Fortier, Inc., a corporation that owns the methanol production facility in Fortier, Louisiana ("Methanex Fortier"); and a marketing subsidiary called Methanex Methanol Company, based in Dallas, Texas ("Methanex US").

34. Methanex Fortier is incorporated under the laws of the State of Delaware. Methanex allegedly indirectly owns all of the shares of Methanex Fortier.

35. Methanex ceased production at the Fortier plant before the Executive Order was issued. It did so because of its opening of a massive, low-cost plant in Chile. The Fortier plant did not supply customers in California in any event, its market being limited to customers in the southeastern United States and along the Mississippi River.

36. Methanex US is allegedly a Texas general partnership of two companies, Methanex Inc. and Methanex Gulf Coast Inc., both incorporated under the laws of the State of Delaware. Methanex allegedly indirectly owns all of the shares of both partners.

37. Methanex US principally functions as a marketing office for sales in the United States of methanol produced by Methanex's facilities in Chile and Canada. It appears that Methanex US also has an auxiliary role as a trading office, purchasing methanol on the open market and selling it to Methanex customers in the United States. Methanex US appears to consist of no more than a number of desks in leased office space manned by employees with telephones and

computers: it apparently has no significant assets and, on a stand-alone basis, earns no significant income from its activities.

B. MTBE

38. MTBE is a hazardous chemical compound produced from methanol and isobutylene. MTBE is used as a fuel additive for two reasons, both born of regulation. First, it is a source of octane, which improves a fuel's resistance to uncontrolled combustion (engine knock). Second, MTBE is an oxygenate: it increases the oxygen content of gasoline.

39. MTBE's use as a source of octane in the United States resulted from federal environmental and public health regulations requiring a substantial reduction of the use of lead in gasoline. MTBE has been used in the United States since the 1970s as an octane-enhancing replacement for lead, primarily in mid- and high-grade gasoline.

40. MTBE's use as an oxygenate in the United States also resulted from federal environmental and public health standards. In 1990, the United States enacted amendments to the federal Clean Air Act that required increased oxygen content in gasoline under two programs for certain areas of the United States, including California. The programs require that oxygenates be added to gasoline to reduce harmful emissions in automobile exhaust.

41. Among other things, the federal programs conditionally require a minimum oxygen content in gasoline of between 2.0 and 2.7 percent by weight, depending on the season. Two percent oxygen by weight is equivalent to approximately 11 percent MTBE by volume.

42. The programs apply to a discrete number of metropolitan areas in the United States with the most severe ozone or carbon monoxide levels. These metropolitan areas include Los

Angeles, Sacramento and San Diego. Certain other areas with high ozone levels can opt into one of the programs.

43. Ethanol is the principal oxygenate used in the winter, with the exception of greater Los Angeles, whose refiners have chosen to use MTBE. MTBE is the principal oxygenate used at other times of the year. Tertiary amyl methyl ether ("TAME") is also used, although infrequently, as an oxygenate. Other oxygenates – including ethyl tertiary butyl ether, diisopropyl ether and tertiary butyl alcohol – are available, but have been used little, if at all.

44. For years, California has regulated the content of gasoline sold in the state in order to combat air pollution – a particularly difficult problem for California because of its large population centers and its unique topographic and climatic conditions. California's regulations are almost always more stringent than the federal regulations, which also apply in the state.

45. Since June 1996, California has required the use of California Phase 2 Reformulated Gasoline ("CaRFG2"), which typically has an oxygen content of 1.8 to 2.2 percent. Thus, since June 1996, MTBE has usually constituted about 11 percent by volume of California gasoline.

C. The California Market for MTBE

46. There are two categories of MTBE producers in the United States: gasoline refiners that produce and mix MTBE into gasoline at their refineries; and merchant MTBE producers that produce MTBE for sale to gasoline refiners and wholesalers.

Eighty-five percent of the MTBE used by California refiners is supplied by merchant MTBE producers in the United States and other countries. The remaining 15 percent of MTBE is produced by certain California refiners at their refineries for their own use.

47. Merchant MTBE producers in the United States are, with one exception (in Wyoming), located on the Gulf of Mexico coast. Practically all of the MTBE produced or consumed in the United States is transported by ship to coastal facilities, with some moved inland by barge, rail or truck.

48. The cost of transporting MTBE produced in the United States from one United States destination to another is substantial. For example, in 1998 the average total cost per ton of MTBE shipped from the Gulf of Mexico to the Atlantic coast of the United States was $9.73, compared with $21.92 for MTBE shipped from the Gulf of Mexico to the Pacific coast. Depending on market conditions, it may be difficult for merchant MTBE producers located in the Gulf of Mexico competitively to ship their product to the Pacific coast.

49. The California market for MTBE therefore is principally served by foreign MTBE producers and, to a much lesser extent, by U.S. merchant MTBE producers and California refiners that purchase methanol and produce MTBE for their own use.

50. Demand for MTBE in California and elsewhere in the United States remained strong throughout 1999 and through the first half of the year 2000.

D. MTBE's Effects On Public Health And The Environment

1. Risks To Drinking Water Supplies And Public Health

51. The United States Environmental Protection Agency ("U.S. EPA") has classified MTBE, a known animal carcinogen, as a possible human carcinogen on the basis of inhalation tests.

52. MTBE has a foul, turpentine-like taste and odor. Even at extremely low concentrations, MTBE can render water unpotable. In controlled studies, MTBE's taste has been detected at concentrations as low as 2.0 parts per billion ("ppb"), and MTBE's odor has been detected at concentrations as low as 2.5 ppb. California has prohibited state public drinking water agencies from delivering drinking water with an MTBE concentration in excess of 5.0 ppb.

53. MTBE is a toxic chemical that is highly soluble in water. Because of its chemical properties, when released into the environment, MTBE contaminates substantially more groundwater and is substantially more difficult and costly to clean up than other components of concern in gasoline, including benzene, toluene, ethylbenzene and xylene (collectively referred to as "BTEX").

54. MTBE is more soluble in water than BTEX and is capable of traveling through soil rapidly. In groundwater, MTBE moves at nearly the same velocity as the groundwater and, therefore, often migrates further than BTEX.

55. MTBE is highly resistant to biodegradation, much more so than BTEX or ethanol, the second most common oxygenate in U.S. gasoline. Actively cleaning up MTBE contamination takes longer and costs substantially more than cleaning up BTEX.

2. Groundwater Contamination

56. Because of its unique chemical properties, MTBE contamination of groundwater presents a significant risk to drinking water supplies in California.

57. Gasoline is one of the most ubiquitous toxic substances in the United States. Because of the vast number of places where it is stored and people who handle it on a daily basis, a significant number of gasoline spills and leaks into the environment is inevitable. Indeed, according to some estimates, the equivalent of a full supertanker of gasoline (about nine million gallons) is released into the environment in the United States every year from leaks and spills.

58. Gasoline can be released into the environment wherever it is stored, transported, transferred or disposed. Specifically, sources of gasoline releases include underground storage tanks ("USTs"), above-ground storage tanks, pipelines, spills (*e.g.*, during fueling operations and from tank trucks, automobile accidents and consumer disposal) and storm water runoff. In addition, certain types of watercraft, particularly watercraft with two-stroke engines, introduce gasoline into surface waters as part of their normal operation, without any accidental leaks or spills.

59. Both the federal government and California have implemented a number of programs to minimize the potential for leaks and spills of gasoline and both enforce laws and regulations intended to prevent and clean up gasoline releases. Despite the existence and implementation of these federal and state programs, a substantial number of releases of gasoline into the environment is inevitable because of the omnipresence of the fuel.

60. Leaks and spills of conventional gasoline generally pose no widespread threat to drinking water supplies because the components of conventional gasoline biodegrade relatively

quickly and are not highly soluble in water. Many spills of conventional gasoline may effectively be left to undergo bioremediation. In those cases where active intervention is required, conventional gasoline releases can often be cleaned up relatively quickly and inexpensively.

61. Leaks and spills of gasoline containing MTBE, however, do pose a substantial threat to drinking water supplies. MTBE binds tightly to surface and groundwater, biodegrades slowly and travels deep underground to reach aquifers. Even a small release of gasoline containing MTBE can have significant adverse effects. For example, a December 1997 car accident in Standish, Maine led to the release of about ten gallons of gasoline containing MTBE. The release contaminated twenty-four private wells with MTBE. MTBE concentrations at three of the wells exceeded 1,000 ppb – a level hundreds of times greater than that at which MTBE's unpleasant taste and odor can be detected by humans.

62. Approximately 30 percent of the 34 million people who reside in California rely on groundwater as a drinking water source.

63. California has experienced some of the worst and most widespread MTBE contamination of groundwater of any state in the United States. This contamination, which stems from a variety of sources, has affected drinking water wells at dozens of sites in California.

64. For example, MTBE contamination forced the closure of groundwater wells that prior to 1996 supplied approximately half of the drinking water of the City of Santa Monica. Some of the wells recorded contamination at concentrations up to 610 ppb.

65. In Glennville, California, residential drinking water wells were contaminated with MTBE at concentrations up to 20,000 ppb. Consequently, since 1997, the town has relied on alternative sources of drinking water.

66. The South Lake Tahoe Public Utility District shut down 35 percent of its public drinking water wells because of MTBE contamination. The contamination forced the district to develop new production wells at substantial expense.

67. During the summer boating season, MTBE concentrations up to 12 ppb have been measured in Donner Lake, a source of drinking water for lakeside residents and downstream communities (including Reno, Nevada).

68. In Shasta Lake, a recreational-use reservoir that is also California's largest drinking water reservoir, MTBE concentrations have been reported from 9 ppb to 88 ppb.

69. Because of MTBE's affinity for water and resistance to biodegradation, cleanup of MTBE contamination takes longer and is more difficult and costly than cleanup of conventional gasoline.

70. For example, the EPA estimates that over $60 million has been spent to date to address the MTBE contamination at one of the two MTBE-contaminated well fields that together had supplied approximately half of Santa Monica's drinking water. The final cleanup of that well field is expected to cost more than $160 million.

E. California's Actions Regarding MTBE

1. Senate Bill 521

71. California Senate Bill 521 (the "Bill"), approved by the Governor on October 8, 1997, provided $500,000 from the Motor Vehicle Fuel Account in the California Transportation Tax Fund to the University of California to conduct a study and assessment of the human health and environmental risks and benefits associated with the use of MTBE. The Bill also required the Governor to certify, after considering the report, the peer-review comments and public testimony, whether using MTBE in gasoline in California posed a significant risk to human health or the environment and, if so, to take "appropriate action." (A copy of the Bill is attached hereto as Exhibit A.)

2. University of California Report

72. As contemplated by the Bill, the University of California issued a competitive, peer-reviewed request for proposals and commissioned the following studies:

- John Froines, Ph.D., University of California, Los Angeles: *An Evaluation of the Peer-Reviewed Research Literature on the Human Health, including Asthma, and Environmental Effects of MTBE*;
- John Reuter, Ph.D. and Daniel Chang, Ph.D., University of California, Davis: *An Integrated Assessment of Sources, Fate & Transport, Ecological Risk and Control Options for MTBE in Surface and Ground Waters, with Particular Emphasis on Drinking Water Supplies*;
- Arturo Keller, Ph.D., University of California, Santa Barbara: *Evaluation of Costs and Effectiveness of Treatment Technologies Applicable to Remove MTBE and Other Gasoline Oxygenates from Contaminated Water*;
- Irwin Suffet, Ph.D., University of California, Los Angeles: *Drinking Water Treatment for the Removal of Methyl Tertiary Butyl Ether from Ground Waters and Surface Water Reservoirs*;
- Catherine Koshland, Ph.D., University of California, Berkeley: *Evaluation of MTBE Combustion Byproducts in California Reformulated Gasoline*; and
- Arturo Keller, Ph.D. and Linda Fernandez, Ph.D., University of California, Santa Barbara: *Risk-Based Decision Making Analysis of the Cost and Benefits of MTBE and Other Gasoline Oxygenates*.

73. These studies were compiled into the University of California report entitled *Health & Environmental Assessment Of MTBE: Report To The Governor And Legislature Of The State Of California As Sponsored By SB 521* ("UC Report"), which was issued in November 1998.

74. The UC Report concluded that there are significant risks and costs associated with water contamination due to the use of MTBE. Specifically, the authors found that if the use of MTBE were to continue at its current level, there would be an increased danger of surface and groundwater contamination. The UC Report concluded that the cost of treatment of MTBE-contaminated drinking water sources in California could be enormous. Moreover, the UC Report concluded that MTBE is an animal carcinogen with the potential to cause cancer in humans.

75. To remedy the serious problems facing California's water supply, the UC Report recommended consideration of phasing out MTBE in gasoline over an interval of several years. The UC Report reached this conclusion in light of the substantial costs associated with cleaning up MTBE contamination if MTBE were not phased out and the ability to achieve comparable air quality benefits without relying on MTBE.

3. Public Testimony

76. Public hearings on the UC Report were held on February 19, 1999 in Diamond Bar, California, and on February 23-24, 1999 in Sacramento, California.

77. Over the course of the three days of hearings, representatives of CARB, the California Energy Commission, the Office of Environmental Health Hazard Assessment, the State Water

Control Resources Board, the Department of Health Services and the State Fire Marshal gave remarks and served as panel members.

78. Authors of the UC Report also made presentations regarding their findings. The panel members and members of the public had an opportunity to ask questions of the presenters at the hearings.

79. Representatives of the Oxygenated Fuels Association, an organization whose members produce MTBE and other oxygenates, were among those who posed questions to the panel of presenters. Other questions were presented by methanol producers, such as Neste Oil, and MTBE producers, such as Huntsman Corporation.

80. After the question and answer sessions, members of the public gave oral testimony. Those testifying included persons affected by MTBE water contamination and individuals associated with the chemical and oil industries, among others.

81. Also, the public was accorded the opportunity to submit written testimony to the panel. The Oxygenated Fuels Association provided a written submission. Methanex also participated in the debate concerning the potential regulation or prohibition of the use of MTBE in California gasoline.

82. In addition, California and federal agencies were given an opportunity to review and comment on the UC Report. On February 22, 1999, the California Air Resources Board ("CARB") provided comments to the California Environmental Protection Agency ("Cal EPA") regarding the UC Report. The UC Report was independently reviewed by the U.S. Geological Survey and the U.S. Agency for Toxic Substances and Disease Registry at the Centers for Disease Control.

4. Executive Order

83. On March 25, 1999, the Governor of California found that, "on balance, there is significant risk to the environment from using MTBE in gasoline in California." This determination, embodied in a certification dated March 26, 1999, was based on the findings in the UC Report, the peer-review comments on the UC Report by the U.S. Geological Survey and the U.S. Agency for Toxic Substances and Disease Registry and the oral and written testimony given at the public hearings.

84. Executive Order No. D-5-99 (the "Executive Order") was signed by the Governor on March 25, 1999. (A copy of the Executive Order is attached hereto as Exhibit B.) The Executive Order called for three principal categories of action by state agencies. First, it directed the California Energy Commission, in consultation with CARB, to develop a timetable for the removal of MTBE from gasoline at the earliest possible date, but not later than December 31, 2002. The Executive Order also called for CARB to adopt California Phase 3 Reformulated Gasoline ("CaRFG3") regulations.

85. Second, the Executive Order directed CARB to request the Administrator of the U.S. EPA to grant California an immediate waiver from the Clean Air Act's requirement of a specified oxygen content in reformulated gasoline. The Executive Order also called for Cal EPA to work with U.S. Senator Feinstein to gain passage of legislation that would grant authority to the U.S. EPA Administrator to waive permanently the Clean Air Act's requirement for a specified oxygen content in reformulated gasoline in states that achieve equivalent air quality benefits using different means.

86. Third, the Executive Order directed CARB and the State Water Resources Control Board to conduct an analysis of the impact of ethanol on the air, surface water and groundwater. In addition, the Executive Order directed the Office of Environmental Health Hazard Assessment to prepare an analysis of the health risks of ethanol in gasoline. The Executive Order called for these reports to be peer-reviewed and presented to the California Environmental Policy Council by December 31, 1999.

87. In addition to its principal directives, the Executive Order required the California State Water Resources Control Board to pursue legislation to ensure that additional substantial financial resources would be available to clean up MTBE contamination. The Executive Order also required the board, in consultation with the California Department of Health Services, to prioritize areas of the state particularly vulnerable to groundwater contamination, as well as cleanup-activities in those areas.

88. The Executive Order did not ban the use of MTBE in gasoline. Instead, it assigned various state agencies a number of tasks that were preparatory steps toward the potential issuance of regulations or legislation addressing problems associated with MTBE contamination of drinking water supplies.

5. Subsequent California Legislative Action On MTBE

89. On October 8, 1999, Senate Bill 989 was approved by the Governor. Senate Bill 989 comprehensively addressed unauthorized releases from USTs. Senate Bill 989 included stringent, new requirements designed to prevent unauthorized UST releases. The bill also included new measures to help improve the speed with which unauthorized releases are

identified and cleaned up in California. The bill made available nearly $1 billion in additional funds to remedy contamination attributable to gasoline and MTBE.

90. Senate Bill 989 also required the California Energy Commission to develop a timetable for the removal of MTBE from gasoline at the earliest possible date. Unlike the Executive Order, the bill did not specify a deadline for the removal of MTBE in California gasoline.

91. Senate Bill 529, approved by the Governor on October 8, 1999, established specific requirements for conducting environmental assessments of any amendments to the CaRFG standards. This law required the California Environmental Policy Council to review the environmental assessments for any amendments and determine whether any proposed change in CaRFG standards would significantly and adversely impact public health or the environment.

6. Actions By California Regulatory Agencies

92. Following the issuance of the Executive Order, CARB held numerous public meetings on proposed regulations that would, among other things, eliminate the use of MTBE in gasoline in California. Those public meetings were held on April 23, 1999 (Los Angeles), May 27, 1999 (Sacramento), June 22, 1999 (Sacramento), August 4, 1999 (Sacramento), August 31, 1999 (Los Angeles), September 28, 1999 (Sacramento) and November 15, 1999 (Sacramento). Participants at some of these meetings included representatives of the methanol industry and the American Methanol Institute, of which Methanex US is a member. Methanex had the opportunity to attend and participate in all of these meetings.

93. On June 28, 1999, the California Energy Commission held a public hearing to discuss findings and recommendations regarding a timetable for the removal of MTBE from California's

gasoline. The California Energy Commission, in consultation with CARB, determined that in order to ensure an adequate supply of gasoline for California consumers, the date for removal of MTBE from California's gasoline should be December 31, 2002.

94. On October 22, 1999, the staff of CARB issued proposed amendments to the CaRFG2 regulations, which included, among other things, a December 31, 2002 prohibition on using MTBE in gasoline and the adoption of the CaRFG3 regulations. The proposed amendments were peer-reviewed, as required by the California Health and Safety Code. The reviewers found that the proposed amendments would preserve the air quality benefits achieved through use of MTBE as an oxygenate in gasoline.

95. On December 9, 1999, after a public hearing, CARB endorsed the proposed amendments to the CaRFG2 regulations with several modifications. As approved by CARB, the proposed amendments included a prohibition on the use of MTBE in California gasoline starting December 31, 2002, and adopted the CaRFG3 standards. In fact, the proposed CaRFG3 regulations would prohibit, as of December 31, 2002, the use of any gasoline oxygenate other than ethanol unless the California Environmental Policy Council determined, based on an environmental assessment, that use of that oxygenate would not present a significant risk to public health or the environment. The proposed CaRFG3 regulations further called for the reduction of the levels in gasoline of sulfur and benzene, a known human carcinogen.

96. Also, on December 9, 1999, CARB directed its Executive Officer to make the proposed amendments, including the December 9, 1999 modifications, to the CaRFG2 regulations available for a supplementary public comment period.

97. On January 18, 2000, the California Environmental Policy Council determined that no significant adverse environmental impact on public health or the environment would result from the proposed CaRFG3 regulations or the use of ethanol in California gasoline.

98. The revised, proposed CaRFG3 regulations were formally released to the public on April 7, 2000. The notice containing the proposed regulatory text was mailed to all persons who had submitted comments on the proposed CaRFG3 regulations. The proposed regulatory text was also made available to the public on the CARB website on April 6, 2000. The deadline for further public comment was April 24, 2000.

99. The proposed CaRFG3 regulations were based on an extensive administrative record, including a comprehensive set of scientific studies concerning the effect of MTBE on air quality, water and human health. The record supporting the regulations included substantial public comments collected in many hearings and substantial California agency responses to those comments.

100. On June 16, 2000, the Executive Officer of CARB signed the CaRFG3 executive order and, on June 26, 2000, forwarded the CaRFG3 regulatory package to the Office of Administrative Law for review.

101. On August 3, 2000, that office approved the CaRFG3 regulations with certain technical modifications. That same day, the regulations were filed with the California Secretary of State. Pursuant to California law, regulations are formally codified and become effective 30 days after filing with the Secretary of State. The CaRFG3 regulations will become effective on September 2, 2000.

102. As of the date of this Statement of Defense, the CaRFG3 regulations do not have the effect of law, and there is no current or future ban in effect on the use of MTBE in gasoline in California.

F. Other State And Federal Government Actions Regarding MTBE

103. Other states and the federal government have also taken steps to reduce or eliminate the use of MTBE in gasoline.

104. In 1994, the State of Alaska cancelled the oxygenated fuels program for certain areas after receiving complaints about health problems associated with MTBE, including headaches and nausea.

105. In November 1998, the U.S. EPA Administrator appointed a Blue Ribbon Panel to provide independent advice and recommendations on maintaining air quality while protecting water quality. The panel consisted of experts on environmental health, petroleum refining, hydrology, air pollution, USTs and other relevant fields. The experts were drawn from government, industry, academia and non-governmental organizations. In September 1999, the panel issued its report: *Achieving Clean Air and Clean Water: The Report of the Blue Ribbon Panel on Oxygenates in Gasoline* (the "Blue Ribbon Report").

106. The Blue Ribbon Report recommended, among other things, that the use of MTBE should be reduced substantially to minimize current and future threats to drinking water. Several Blue Ribbon Panel members concluded that the use of MTBE in gasoline should be completely eliminated.

107. In late 1998, the State of Maine withdrew from the federal oxygenated fuels program after discovering that approximately 16 percent of wells in the state were contaminated with MTBE.

108. On March 20, 2000, the U.S. EPA Administrator and the U.S. Secretary of Agriculture announced two actions to eliminate or reduce significantly the use of MTBE in gasoline.

109. First, the U.S. EPA and the U.S. Department of Agriculture issued a set of legislative principles recommending, among other things, immediate congressional action to amend the Clean Air Act to provide the authority to eliminate or reduce significantly the use of MTBE in gasoline.

110. Second, the U.S. EPA issued an Advance Notice of Proposed Rulemaking under Section 6 of the Toxic Substances Control Act as a first step toward regulatory action to eliminate or limit the use of MTBE in gasoline. The U.S. EPA issued the advance notice to begin a process to ensure that the nation's water resources would be protected in the absence of congressional action.

111. To date, several bills proposing to reduce or eliminate the use of MTBE in gasoline have been introduced in Congress.

112. As of the date of this Statement of Defense, action has been taken or proposed in at least 18 states to restrict or ban the use of MTBE in gasoline or to mandate the use of a substitute oxygenate. For example, on May 24, 2000, New York State banned the use of MTBE in gasoline sold in New York as of January 2004, and on June 1, 2000, the State of Connecticut also prohibited the use of MTBE in gasoline in Connecticut by October 2003.

III. POINTS AT ISSUE

A. Objections To Jurisdiction And Admissibility

1. The Bill And The Executive Order Are Not Measures "Relating To" Methanex Or Its Investments

113. The scope of the NAFTA's Chapter 11 for the claims at issue here is limited to "measures adopted or maintained by a Party *relating to*: (a) investors of another Party; [or] (b) investments of investors of another Party in the territory of the Party." NAFTA art. 1101(1)(a)-(b) (emphasis supplied). Neither the Bill nor the Executive Order is a "measure . . . relating to" an investment of Methanex in the United States. Methanex's claims are not within the scope of the United States' consent to arbitrate Chapter 11 claims.

114. In the context of Chapter 11, the words "relating to" in Article 1101 require that there be, at a minimum, a *legally significant* connection between the measure and the investment or investor.

115. The Bill fails to satisfy the requirement of a legally significant connection between a measure and an investment or investor. The Bill authorized funding for the University of California to conduct research and prepare a study on the environmental and public health risks and benefits of MTBE. The Bill in no sense related to Methanex, Methanex US or Methanex Fortier.

116. Nor is there a legally significant connection between the Executive Order and Methanex or its U.S. investments. The Executive Order directed two California agencies to develop a timetable in preparation for the potential promulgation of regulations addressing MTBE in

gasoline. That directive, however, had no connection to Methanex, Methanex US or Methanex Fortier that was legally sufficient to give rise to a Chapter 11 claim.

117. Methanex's claims concerning the Bill and the Executive Order are therefore not within the scope of Chapter 11 or the United States' agreement to arbitrate claims under Chapter 11.

2. Article 1116 Grants No Jurisdiction Over Claims For Injuries Allegedly Suffered By An Enterprise

118. The sole jurisdictional basis invoked by Methanex is Article 1116 of the NAFTA. Methanex, however, has no standing to invoke the Tribunal's competence under this Article.

119. NAFTA provides two separate avenues of relief to investors. Article 1116 permits a "claim by an investor of a Party *on its own behalf*" that "*the investor* has incurred loss or damage." (Emphasis supplied.) Article 1116 does not recognize claims by a shareholder for injury suffered by a corporation.

120. By contrast, Article 1117 permits a claim by an investor, "*on behalf of an enterprise*" that the investor owns or controls, that "*the enterprise* has incurred loss or damage." (Emphasis supplied.) The claim and the damage asserted under Article 1117, thus, are those of the *enterprise*, not the investor. Indeed, as Article 1135 makes clear, any award under Article 1117 for an injury to an enterprise must be paid to the enterprise, not to the investor. *See* art. 1135(2)(b).

121. Methanex does not allege any loss that is in any way distinct from the purported losses suffered by Methanex US and Methanex Fortier. Methanex's alleged loss in customer base, in good will, in the market for methanol in California and elsewhere, in a loss of return on "capital investments," in an increased cost of capital and in an unexplained "loss . . . of a substantial

amount of its investment" are all derivative of alleged injuries to Methanex US and Methanex Fortier.

122. In sum, Methanex can claim no loss independent of that allegedly suffered by the enterprises at issue. Article 1116, therefore, provides no basis for the Tribunal's jurisdiction over the claims asserted.

3. Inadequate Waiver: Failure To Satisfy A Jurisdictional Precondition Of Article 1121

123. Article 1121(1)(b) of the NAFTA provides that an investor may submit a claim under Article 1116 only if the investor and, where the claim is for loss or damage to an interest in an enterprise of another Party that the investor owns or controls directly or indirectly, the enterprise, waive their rights to initiate or continue any domestic proceedings seeking the payment of monetary damages allegedly caused by the measure. Article 1121's requirements are jurisdictional: failure to satisfy any one of the Article's requirements is fatal to a Chapter 11 tribunal's jurisdiction.

124. Methanex, in Schedule I to its Notice of Arbitration, submitted an instrument that purports to waive its own rights and the rights of Methanex US and Methanex Fortier. The instrument is signed by Randall Milner, Corporate Counsel and Assistant Corporate Secretary, on behalf of Methanex Corporation.

125. This instrument does not effectively waive the rights of either Methanex US or Methanex Fortier. Methanex US is a Texas general partnership, and Methanex Fortier is a Delaware corporation. Under established corporate law, a shareholder as such has no power

to waive the rights of a corporation or a general partnership of corporations the shares of which the shareholder holds.

126. Neither Methanex, Inc. nor Methanex Gulf Coast Inc., the general partners of Methanex US, has provided a waiver on behalf of Methanex US. Nor has any director or officer of Methanex Fortier acting in that capacity provided a waiver on behalf of Methanex Fortier. The instrument submitted by Methanex cannot effectively waive the rights of Methanex US or Methanex Fortier under applicable laws. The requirements of Article 1121 have not been met, and, thus, this Tribunal lacks jurisdiction over Methanex's claim.

4. Methanex's Article 1110 Claim Fails To Identify An Expropriated "Investment" Within Chapter 11's Grant Of Jurisdiction

127. Methanex's claim under Article 1110 is not within the scope of Chapter 11 because it fails to allege a direct or indirect expropriation of anything that constitutes an "investment" under the NAFTA.

128. Methanex does not claim – because it cannot – that Methanex US or Methanex Fortier has been nationalized or expropriated. Instead, it claims that the California measures "constitute[] a substantial taking of Methanex US' and Fortier's *business*." [2] At bottom, Methanex's claim is that the California actions will eliminate the market for MTBE for use in California gasoline and, therefore, reduce the amount of methanol sold by Methanex US or Methanex Fortier to MTBE producers in the future.

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[2] Statement of Claim ¶ 35 (emphasis supplied). Methanex also alleges that "[t]he measure constitutes a substantial taking of . . . Methanex's investment in Methanex US and Fortier." *Id*. The Statement of Claim provides no information concerning this alleged investment or how it could conceivably be viewed as having been expropriated. To the extent this claim differs from others pleaded, it is stated with insufficient particularity to engage the Tribunal's jurisdiction.

129. Methanex's claim fails to identify any interest that meets even the expansive definition of "investment" for purposes of Chapter 11. Article 1139 specifies the legal rights and interests that can constitute an "investment" for purposes of Chapter 11. The colloquial notion of a "business" of an enterprise, as alleged by Methanex in its Statement of Claim, does not appear in Article 1139's definition. The definition in no way encompasses a mere hope that profits may result from prospective sales to a particular market segment in the future.

130. Because Methanex has failed to identify any "investment" that has allegedly been nationalized or expropriated, its claim under Article 1110 does not fall within the United States' consent to arbitration in Section B of Chapter 11.

5. Methanex Has Not Incurred A Loss Or Damage By Reason Of The Bill Or The Executive Order

131. Article 1116(1) of the NAFTA provides that an investor may submit a claim to arbitration under Chapter 11 only when that investor "has incurred loss or damage by reason of, or arising out of, [a breach of Section A of Chapter 11]."

132. The Bill appropriated money to the University of California for it to conduct a study. No alleged injury to Methanex could have been "by reason of, or arise[n] out of," the mere funding of a study.

133. The Executive Order similarly could not have caused Methanex any cognizable loss or injury. The Executive Order directs California agencies to develop a timetable for the elimination of MTBE in gasoline no later than December 31, 2002. Currently, and certainly as of the date that Methanex filed its claim, there is (and was) no measure in effect banning the use of MTBE in California's gasoline.

134. Since the issuance of the Executive Order, CARB has issued proposed CaRFG3 regulations which include a prohibition on the use of MTBE in gasoline in California as of December 31, 2002. The CARB regulations, however, are not the subject of Methanex's Notice of Arbitration or Statement of Claim and have not become effective as of the date of this Statement of Defense in any event.

135. Given the nature of the Bill and the Executive Order, Methanex can allege no compensable injury or damage.

6. Methanex's Claims Are Not Admissible Because Its Alleged Injuries Are Too Remote

136. Under a well-established principle of customary international law applicable to Article 1105(1) and 1110 claims such as those advanced here, only acts that are the proximate cause of injury to an alien can engage the responsibility of a State under international law and give rise to standing to claim for such an injury. NAFTA incorporates this principle in Article 1116, which recognizes that an investor may submit a claim only for loss or damages "by reason of, or arising out of," a breach of Section A of Chapter 11.

137. International tribunals applying this principle have repeatedly found that a claimant lacks standing in circumstances where its alleged injury resulted solely from an action's adverse effect on a person with whom the claimant has a contractual relationship. For example, as the International Court of Justice recognized in the *Barcelona Traction* case, "Creditors do not

have any right to claim compensation from a person who, by wrongdoing to their debtor, causes the loss. In such cases, the interests of the aggrieved are affected, but not their rights."[3]

138. Application of this principle here compels a finding that Methanex's claims are inadmissible. Methanex produces methanol, not MTBE. Its claimed injuries derive entirely from the effects Methanex anticipates from a prospective MTBE ban on MTBE producers that have bought methanol from Methanex in the past. Indeed, the causal link is even more attenuated here than in the cases referenced above: to the extent that the challenged actions affect Methanex US and Methanex Fortier at all, they do so not by causing a *breach* of *existing* contracts with methanol customers, but only by reducing the likelihood that MTBE producers will enter into contractual relations with Methanex's subsidiaries *in the future.* Given this and the other circumstances of this case, Methanex's claim is far too removed from the measures at issue to be admissible.

7. Methanex Has No Admissible Claim Under Article 1105

139. Methanex's claim under Article 1105(1) is inadmissible because it fails to identify – because there is none – any customary international law standard of treatment incorporated into that Article that is applicable to the challenged actions. A measure can breach Article 1105(1), entitled "Minimum Standard of Treatment," only if it fails to accord "treatment in accordance with international law." Because there is no standard of customary international law implicated

[3] *Barcelona Traction Light & Power Co., Ltd.*, (Belg. v. Spain), 1970 I.C.J. ¶ 44 (Judgment of Feb. 5, 1970).

by the measures at issue, Methanex fails to state a breach of Section A of Chapter 11, as required by Article 1116. Its claim therefore is not admissible.

140. Methanex asserts essentially two complaints concerning the Bill and the Executive Order. First, it complains about the *process* by which the measures were adopted. It asserts that the Executive Order was "based on a process which lacked substantive fairness"; "was based solely on the UC Report" and that the report in turn lacked "a proper risk characterization"; relied on "an extraordinarily scant database . . . and broad assumptions"; "contained a badly flawed exposure assessment and cost/benefit analysis"; and failed adequately to "discuss alternative solutions and remediation." Statement of Claim ¶¶ 32-33. Second, Methanex complains about the *substance* of the measures, asserting that the measures were "arbitrary" and "go[] far beyond what is necessary to protect any legitimate public interest." *Id*. ¶ 33.

141. Entirely apart from their lack of factual merit – for California's notice and comment procedures were amply fair and adequate – Methanex's assertions implicate no standard of customary international law incorporated into Article 1105(1). Customary international law imposes no constraints on the *processes* by which States adopt executive or legislative measures: the community of nations includes monarchies and dictatorships, as well as democracies. Each of these forms of government is capable of issuing laws and regulations that are valid under customary international law, whether or not they follow the procedures, such as public notice and comment, favored by many democracies. Methanex's assertions directed to the process by which the challenged measures were issued are misplaced.

142. Customary international law does impose a discrete number of substantive constraints on legislative and executive measures. Such substantive constraints include, for example, the rule of compensation for expropriation, which the NAFTA Parties specifically incorporated, as modified, in Article 1110. Other substantive constraints are recognized by those principles of customary international law governing State responsibility for injury to aliens relevant to investment, which the NAFTA Parties referenced in Article 1105(1). There is, however, no customary international law standard that requires States to adopt only "good" legislation or decrees, as Methanex suggests. Because Methanex has not – and cannot – identify any substantive standard of customary international law implicated by the measures here, its claim under Article 1105(1) is inadmissible.

B. There Is No Liability For The Acts Alleged

1. There Has Been No Expropriation Of Methanex's Investments

143. The actions challenged by Methanex have none of the traditional indicia of an expropriation. California has not nationalized or confiscated Methanex's investments in the United States. California has not interfered with Methanex's use of its U.S. investments. Moreover, the type of action at issue here – one to protect public health – is not, absent extraordinary circumstances not present here, one that can be deemed expropriatory. Finally, particularly in light of the fact that the market for MTBE in gasoline was created by regulation, Methanex could have no reasonable investment-backed expectation that MTBE in gasoline would not be further regulated or banned.

144. To demonstrate a violation of Article 1110, Methanex must prove that its *investment* in another NAFTA Party has been expropriated. Methanex's Statement of Claim identifies only two relevant U.S. subsidiaries; the only purported investments alleged to have been expropriated are the "businesses" of those subsidiaries. Neither Methanex US, Methanex Fortier nor their "businesses," however, have been expropriated.

145. First, it is beyond dispute that there has been no direct expropriation. Neither Methanex US nor Methanex Fortier has been nationalized or confiscated.

146. Second, California has taken no action that has had the effect of indirectly expropriating Methanex US's or Methanex Fortier's "businesses," even assuming that those could be construed as "investments" within Chapter 11. The alleged expropriatory actions have not interfered with Methanex's right to use, enjoy or dispose of its investments. In other words, Methanex has suffered no deprivation of its property rights.

147. Methanex's control over both subsidiaries remains intact. None of the investments' physical assets have been taken away. The management of Methanex US and Methanex Fortier has not been disturbed. Methanex US and Methanex Fortier retain the ability to manufacture and market methanol. And California has not transferred any of Methanex US's or Methanex Fortier's property to itself or any other entity.

148. Methanex Fortier's sole business is manufacturing methanol at its Fortier, Louisiana plant. The Fortier plant, however, has been idle since *before* the announcement of the Executive Order and never supplied customers in California in any event. Methanex idled the plant due to the global oversupply of methanol, resulting low prices and Methanex's opening of

a new, lower cost facility in Chile. The California actions did not interfere with Methanex Fortier's business and could in no way constitute an indirect expropriation of Methanex Fortier.

149. Similarly, Methanex US's business is marketing methanol in the United States. Methanex US remains in control of all of its assets, and its right to market methanol throughout the United States – including California – has not been disturbed by any of California's actions.

150. Indeed, the only circumstance alleged by Methanex to constitute an interference with its property is Methanex's subsidiaries' anticipated reduced sales of methanol to MTBE producers due to the future elimination of the market for MTBE in gasoline in California. Methanex, however, has no property interest in being assured a market for methanol as a feedstock for MTBE to be used in California's gasoline. Neither municipal law nor international law recognizes a loss of the continued existence of a particular market segment as a permissible basis for an expropriation claim. Nor has Methanex identified any other property interest that could be the subject of an expropriation claim under Article 1110.

151. Methanex manufactures and markets methanol, not MTBE. The uses of methanol are much more diversified than MTBE's use in gasoline. Methanol is used to produce formaldehyde and acetic acid, among other things, which are used, in turn, to produce a wide variety of items, including fabrics, plastic bottles and laminated wood products. Only a fraction of Methanex's production of methanol is sold to MTBE producers, and only a fraction of that is used to produce MTBE for the California market. The actions challenged by Methanex do not, in any way, restrict the ability of Methanex US or Methanex Fortier to manufacture and market methanol for use in the United States or anywhere else in the world, nor do they deprive

Methanex US or Methanex Fortier of their ability to sell methanol to producers of MTBE for use in any place other than in California.

152. Moreover, the challenged actions were environmental measures taken to protect the public health by safeguarding the public's drinking water supply. Customary international law recognizes that, absent extraordinary circumstances, States are not liable to compensate aliens for economic loss incurred as a result of a nondiscriminatory action to protect the public health. This rule of customary international law encompasses environmental measures, such as those at issue here, that are taken to protect the public health.

153. The NAFTA also recognizes a State's sovereign right to protect public health and the environment. The preamble of the NAFTA notes the Parties' resolve to "PRESERVE their flexibility to safeguard the public welfare; . . . [and] STRENGTHEN the development and enforcement of environmental laws and regulations." Article 1101(4) requires that Chapter 11 be construed so as not "to prevent a Party from providing a service or performing a function such as . . . social welfare . . . [or] health . . . in a manner that is not inconsistent with this Chapter." *See also* NAFTA art. 1114(1)-(2) & the North American Agreement on Environmental Cooperation.

154. California's actions were taken to protect the public's drinking water and are not discriminatory. Nor can they be viewed as bearing any of the other hallmarks of expropriation recognized by international law.

155. Finally, Methanex could have no reasonable investment-backed expectation that MTBE would neither be further regulated nor banned anywhere in the United States in the future. MTBE producers operate in a highly regulated environment. They necessarily operate under

the risk that their product may be regulated in the future. Indeed, insofar as it relates to the sale of methanol to producers that manufacture MTBE, Methanex's business was born of regulation: the use of MTBE as an octane enhancer and an oxygenate arose in direct response to the adoption in 1973 of regulations limiting lead in gasoline and the 1990 amendments to the Clean Air Act. Methanex, as a producer of a feedstock for MTBE, was necessarily aware of the origins of the market for MTBE in gasoline and operated under the risk that the regulations that gave rise to that market segment could change and eliminate the market segment those regulations created.

156. In sum, Methanex's Article 1110 claim bears none of the indicia of an expropriation under international law. Its claim is without merit.

2. The Measures Do Not Breach Any Applicable Standard of Treatment

157. As noted above, customary international law imposes no constraints on the process by which States adopt executive or legislative measures and the measures at issue implicate no substantive customary international law standard. Methanex's Article 1105(1) claim fails because there is no standard of customary international law incorporated into that Article that is applicable to actions such as those at issue here.

Nonetheless, even if the acts that Methanex challenges were subject to Article 1105(1), Methanex's claim would fail on the merits.

158. *First*, the actions taken by California with respect to the Bill and the Executive Order were amply justified. MTBE is a hazardous substance that renders water unpotable at very low

concentrations. It is undisputed that MTBE has contaminated ground and surface water in California.

159. The Bill – which provided money for a study of the effects of MTBE on public health and the environment – was an appropriate response to the growing body of reports of MTBE contamination of drinking water in California and elsewhere. The Executive Order – which was based on the UC Report, its peer-reviewed findings, written comments and three days of public hearings – was likewise amply justified. Moreover, the administrative actions taken since the Executive Order was signed, including the CaRFG3 regulations, were taken only after further study, review, numerous public hearings and workshops and consideration of written comments by government agencies and members of the public.

160. Methanex's assertion that the Executive Order is "arbitrary" because of alleged deficiencies in the UC Report is baseless. That report is based on accepted scientific principles properly applied. Moreover, any alleged deficiencies were fully aired and addressed in the peer-review and public-comment process that led to the adoption of the Executive Order and the CaRFG3 regulations.

161. *Second*, the process by which the measure was adopted did not lack "substantive fairness." As noted above, the Executive Order was based on extensive oral and written comments on the UC Report submitted by the public and several California agencies. Several authors of the UC Report and representatives from various California agencies made presentations regarding the UC Report during three days of public hearings. Oral and/or written comments were submitted by numerous industry representatives including Methanex, the Oxygenated Fuels Association, the American Methanol Institute, individual MTBE producers

(such as the Huntsman Corporation) and other individual methanol manufacturers (such as Neste Oil and the Atlantic Richfield Company). Thus, Methanex had ample, meaningful opportunities to comment on the proposed ban of MTBE in California's gasoline and the process by which the Executive Order was issued was fair.

162. *Third*, Methanex's assertion that the Executive Order focused on only one harmful component of gasoline adds nothing to its Article 1105 claim. As an initial matter, there is not, as Methanex suggests, any customary international law standard that requires a State to adopt comprehensive legislative or executive measures rather than regulate specific components of a broader problem. In any event, the Executive Order directed various California agencies to prepare peer-reviewed reports on the public health and environmental effects of alternative oxygenates and to pursue legislation to ensure that additional financial resources of up to $1 billion were available to remedy MTBE contamination. And the CaRFG3 regulations would ban the use in gasoline of *any* oxygenate other than ethanol, which is the only oxygenate for which a full environmental assessment has been completed, unless the California Environmental Policy Council determines that the subject oxygenate will not present a significant risk to public health or the environment.

163. *Fourth*, California considered the effectiveness of existing and alternative methods for dealing with MTBE contamination. Contrary to Methanex's suggestion, both the federal government and California have enacted and enforced legislation to prevent contamination from leaking USTs. In fact, California enhanced its laws dealing with gasoline releases as contemplated by the Executive Order. Notwithstanding these efforts, releases and spills are inevitable given the vast amount of gasoline with MTBE that is stored, transported and handled,

and the myriad opportunities for leaks, spills and emissions as a result of accidents, natural disasters and the lawful operation of watercraft. Moreover, unlike releases of conventional gasoline, releases of gasoline containing MTBE are more likely to reach and contaminate water sources, are generally not subject to bioremediation and are extremely costly to clean up. California's actions were amply justified by chemical characteristics and public-health and environmental threats unique to MTBE.

164. *Finally*, the Executive Order was issued after consideration of the interests of Methanex and Methanex US. The public, including Methanex and its U.S. subsidiaries, had ample notice of, and opportunity to comment in writing and orally on, the phase out of MTBE before the Executive Order was issued.

165. Thus, Methanex's Article 1105(1) claim fails on the merits: the Bill and the Executive Order suffer from none of the defects on which Methanex relies to support its assertion that their adoption breached the United States' obligation to provide Methanex US treatment in accordance with international law.

C. Methanex's Damages Claims Are Without Merit

166. Methanex's claims for $970 million in damages are without merit. Although the Statement of Claim provides no information concerning how this amount was calculated, Methanex stated, in public announcements accompanying the filing of its claim, that the amount was broadly based on the long decline in its share price.

167. Methanex's claim of loss based on a decline in its share price is without support. The financial markets effectively shrugged at the announcements of the Bill and the Executive Order:

neither announcement provoked the sudden surge in trading volume and substantial change in share price that mark an event that materially affects market valuation of equity shares. The long-term decline in Methanex's share price reflected overcapacity in the methanol industry and other factors, not the measures complained of here.

168. Methanex's claim of loss based on the decline in the global price of methanol is similarly without merit. The global price of methanol remained relatively low until recently because of the construction of a number of new, low-cost plants in a cyclical industry in which capacity already exceeded demand – not because of the California measures at issue here. Indeed, Methanex's suggestion to the contrary is belied by the fact that the global price of methanol has *increased* substantially since the announcement of the Executive Order in March 1999.

169. The other losses claimed by Methanex are not admissible under the principles of international law that inform the interpretation of Chapter 11. There is no recognized property right to a "customer base," a "market for methanol in California and elsewhere," or any specific rate of "return . . . on capital investments." Injuries to such non-existent "rights" cannot form the basis of a Chapter 11 claim. Nor is the "good will" of a business a property right that by itself is capable of being expropriated under customary international law.

170. Finally, neither Methanex's Statement of Claim nor its Notice of Intent to Submit a Claim to Arbitration provides any information concerning its vague claimed loss "of a substantial amount of its investment in Methanex US and Fortier." This claim, to the extent that it purports to be based on a loss independent of those already addressed, has been pleaded with insufficient particularity to satisfy the requirements of Chapter 11 for a claim to be submitted to arbitration.

171. For the avoidance of doubt, the United States denies each and every allegation of the Statement of Claim not specifically and unambiguously admitted in this Statement of Defense.

IV. RELIEF SOUGHT

172. For the foregoing reasons, the United States respectfully requests that this Tribunal render an award: (*a*) in favor of the United States and against Methanex, rejecting Methanex's claims in their entirety and with prejudice; and (*b*) pursuant to paragraphs 1 and 2 of Article 40 of the UNCITRAL Arbitration Rules, ordering that Methanex bear the costs of this arbitration, including the United States' costs for legal representation and assistance.

Respectfully submitted,

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