BEFORE THE HONORABLE ARBITRAL TRIBUNAL ESTABLISHED PURSUANT TO CHAPTER ELEVEN OF THE NORTH AMERICAN FREE TRADE AGREEMENT (NAFTA)

MARVIN ROY FELDMAN KARPA,
CLAIMANT

VS.

THE UNITED MEXICAN STATES,
RESPONDENT

ICSID CASE NO. ARB(AF)/99/1

REJOINDER

COUNSEL FOR THE RESPONDENT:
Hugo Perezcano Díaz

ASSISTED BY:

Secretaría de Economía
Máximo Romero Jiménez
Fernando Reséndiz Wong

Thomas & Partners
J. Christopher Thomas
J. Cameron Mowatt
Rolando García
Carlos García

Shaw Pittman
Stephan E. Becker
Sanjay Mullick

REJOINDER

I. INTRODUCTION

1. The Reply does not respond to the main legal arguments and the facts presented in the Counter-Memorial. However, it presents a radical shift in focus from the Claimant's Memorial.

2. The Reply does not address the following key points made in the Counter-Memorial:

a) since the claim involves taxation measures, Article 2103 circumscribes the matters properly before this Tribunal, and precludes the Claimant's direct reliance upon Article 1105;

b) the Tribunal's earlier Interim Decision on Preliminary Jurisdictional Matters also circumscribes the matters properly before this Tribunal;

c) there are limits on the Tribunal's jurisdiction *ratione temporis*;

d) the claim to the payment of rebates for October-December 1997, which the Memorial described as a claim to a "tax refund"[1], does not fall within the definition of a protected "investment" under Article 1139 but rather is covered by the exclusion language of that definition;

e) the Claimant's reliance upon cases decided by the Iran-U.S. Claims Tribunal is inapposite due to the narrower scope of NAFTA Article 1110;

f) similarly, Article 1110 is narrower than Section 712 of the *Restatement (Third) of the Foreign Relations Law of the United States*, also relied upon by the Claimant;

g) the differing competencies of the domestic courts and international arbitral tribunals must be kept in mind by this Tribunal;

h) the *Azinian* Award addresses a NAFTA claim that is based upon domestic court findings concerning legal rights at domestic law; and

i) there has been no serious attempt to respond to the central findings of the Respondent's expert report on damages.

3. The Claimant also refuses to admit transactions, documents and other facts that would appear to any objective and reasonable observer to be irrefutable. These include:

a) when complying with the Supreme Court's ruling, SHCP informed the District Judge that it had requested invoices with the IEPS tax separately stated from

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1. Memorial at paragraph 237.

CEMSA and the Judge did not object to that as being inconsistent with the Supreme Court's ruling and CEMSA expressly complied with that requirement;

b) the audit of CEMSA revealed irregularities besides a lack of invoices separately stating the IEPS tax paid;

c) the Claimant has considerable knowledge of the ownership and general business affairs of Lynx Exportadora and Compañía Exportadora Mexicana, two of his principal U.S. customers, suppliers and financiers;

d) the Claimant was well aware of the destination of the goods shipped to the United States; and

e) companies described in the Memorial as CEMSA's "competitors" were to the Claimant's knowledge centrally involved in his shipments to the United States.

4. The Reply's Admissions and Denials also include denials of CEMSA's own invoices, pediments, air waybills, and written communications with the Poblanno-Gámez-Guemes network[2].

5. Perhaps most striking, in view of the Memorial's great reliance upon the Supreme Court's decision and the Counter-Memorial's extensive discussion of the two Fiscal Court decisions, the IEPS rebate denials for October-December 1997, and the 1998 amendment to the IEPS Law, respectively, is the fact that, other than in the most cryptic fashion, the Reply does not address fully the 31 May 2001 appellate decision of the Circuit Court, discussed below, which revoked the Fiscal Court's decision of 16 June 2000.

6. The Tribunal will recall that the Counter-Memorial pointed out that the decision of 16 June 2000 of the Fiscal Court, under appeal, had initially upheld the argument advanced by the Claimant in both the domestic proceedings and in this arbitration, namely, that CEMSA could claim the IEPS rebates without possessing invoices. This was discussed at length at paragraphs 6-11, 254-268, and 359-385 of the Counter-Memorial. The Respondent pointed out that SHCP disagreed with the Fiscal Court and that it was appealing the judgment. The Respondent recognized that the court of appeal might uphold the Fiscal Court's application of the so-called principle of "impossibility", a principle that the Claimant's expert, Mr. Loperena, relied upon in his first expert report[3].

7. On 31 May 2001, after the Counter-Memorial was filed, the Circuit Court rendered its decision, granting SHCP's appeal and overturning the Fiscal Court. The Circuit revoked the Fiscal Court's decision in its entirety, and remanded it with instructions to the Fiscal Court to issue a new one in strict adherence to the applicable law.

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2. See, for example, the denials to paragraphs 460-463 of the Counter-Memorial.

3. See paragraphs 14 and 380-385 of the Counter-Memorial.

8. This juridical fact should have been fully addressed in the Reply. However, all that appears is found at paragraph 50, where after discussing the Fiscal Court's decision, it is stated that:

> On June 11, 2001, the Circuit Court issued an opinion remanding the case to the Fiscal Court for reconsideration without dictating the outcome to the Fiscal Court. While the Circuit Court disagreed with the reasoning of the Fiscal Court on certain points, it did not address the "impossibility" issue on factual or legal grounds.

9. This is a mischaracterization of the Circuit Court's decision. In response to SHCP's appeal, the Circuit Court voted in a public session to revoke the Fiscal Court's decision. The Circuit Court has not yet issued its written decision containing its detailed reasoning and specific instructions, and it has, therefore, not been officially notified to the parties. It is not accurate to say that the Circuit Court did not address the "impossibility" issue; in fact, the Fiscal Court's ruling, including on that issue, has been completely set aside.

10. Now, in sharp contrast to the Memorial and statements which urged this Tribunal to accept certain Mexican court decisions as conclusive evidence of the Claimant's domestic legal rights[4], the Claimant argues that the "decisions of the Mexican courts...should not be given any preclusive effect by the Tribunal"[5].

11. Similarly, in contrast to his first opinion, which relied upon the Fiscal Court's use of the so called principle of impossibility[6], Mr. Loperena's second expert opinion does not even mention the Circuit Court's overturning of the judgment upon which he earlier relied.

12. As discussed at length in the Counter-Memorial, to accept the Claimant's arguments that it was entitled to IEPS rebates without being in possession of proper invoices would be to oust the jurisdiction of the Mexican courts and to substitute the Tribunal's view of rights under domestic tax law for those of the domestic courts. In fact, the decisions of the Mexican courts eliminate the premise of the Claimant's argument.

13. The Reply claims at paragraph 34 that:

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4. See Professor Swan's first affidavit at paragraph 58 where he stated in strong terms:

> "For the Tribunal, the question is the effect to be given the Mexican Court's judgment at the international level under NAFTA Article 1110(1)(a), not its technical effect under Mexican law. At the international level the decision must be honored as a definitive normative statement until such time as it s retracted or modified by another equally authoritative Mexican judicial pronouncement.
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> "Even if the judgment of the Supreme Court of Justice is not formally binding on the Tribunal, any attempt by the Tribunal to revise or 'second-guess' that judgment would be unseemly and an embarrassment to the whole investor-State dispute settlement experiment in NAFTA."

5. Reply at paragraph 51.

6. See Memorial Expert opinion of Carlos Loperena at pages 17-22.

> In effect, Respondent is asking the Tribunal to cede jurisdiction over the dispute to domestic courts who have no competence to address the NAFTA issues that Claimant has placed before the Tribunal.

14. To the contrary, the Respondent has not objected to the consideration of issues that the Tribunal is properly seized with under Section B as international law questions under Chapter Eleven. It has merely argued, consistent with the Interim Decision on Preliminary Jurisdictional Issues, that domestic law issues are beyond the scope of the submission to arbitration and that the Claimant is asking the Tribunal to address domestic law issues in place of the domestic courts.

15. The Reply continues to seek that this Tribunal determine CEMSA's rights under Mexican law. For instance, at paragraph 33 of the Reply, the Claimant contends that: "...If the Tribunal determines that Claimant was entitled to IEPS rebates in 1996-97... that ruling will be binding on Respondent's tax authorities..." and at paragraph 48 the Claimant requests the Tribunal to grant him relief as an alternative to having his legal situation under Mexican tax law determined by the competent Mexican courts:

> The second matter [the Fiscal Court proceeding involving CEMSA and IEPS rebates], which has not been resolved and could be withdrawn if the Tribunal awards the relief requested, involves CEMSA's challenge to Hacienda's resolution of March 1, 1999 assessing CEMSA more than US $ 25 million for IEPS rebates paid in 1996 and 1997, interest and penalties ("the Assessment case.")...

16. Similarly, at paragraph 43[7] the Claimant accepts that the Supreme Court of Justice did not review the "mechanics" of rebates under the IEPS Law (*i.e.*, the operation of the tax rebate system described by the Respondent at paragraphs 83-101 of the Counter-Memorial), but nevertheless requests this Tribunal to make findings on the application of the Mexican Constitution and Mexican tax laws that not even the Supreme Court, the Fiscal Court or the circuit courts have made in order to determine that Mexican tax laws grant him or CEMSA certain rights. He requests this Tribunal to ignore, or even overturn, decisions by the Mexican courts that have already determined the limited scope of the Supreme Court decisions in the

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7. That paragraph states:

> "The Counter-Memorial is wrong in saying that the entitlement asserted by Claimant is 'undecided in present Mexican jurisprudence' (CM ¶ 363), and wrong in its narrow construction of the 1993 Supreme Court Decision (CM ¶ 345). In holding the 1991 IEPS amendment unconstitutional, a unanimous Supreme Court ruled in both the CEMSA and LYNX cases that the Mexican government cannot discriminate between producers and resellers in the administration of IEPS rebates on cigarette exports; the 0% tax rate applies to both. It may be that the Court did not review the 'mechanics; of the IEPS Law, and its decision does not preclude the application of reasonable, non-discriminatory procedures. But the Mexican Constitution as propounded by the Supreme Court prohibits discriminatory manipulation of the IEPS law to favor producers over resellers by both the Mexican Congress and Executive officials."

CEMSA and *Lynx* cases[8], and a circuit court's conclusion that the invoice requirement under Article 4 of the IEPS Law is not contrary to the principles of tax equality[9].

II. THE TRIBUNAL'S JURISDICTION TO CONSIDER THE CLAIMS ADVANCED IN THE MEMORIAL

17. The Reply does not fully address the Counter-Memorial's submissions on jurisdiction, in many cases not responding at all to the Respondent's points. In the following, the Respondent comments on certain jurisdictional matters that were addressed in the Reply.

18. The Reply confuses two distinct objections raised by the Respondent: one dealing with the Tribunal's lack of competence to investigate violations of domestic law (see Counter-Memorial, paragraphs 37-43); and the other dealing with the settled principle of customary international law that requires local remedies to be exhausted (see Counter-Memorial paragraphs 283-286 and 359-385). The Reply's mischaracterization of the Respondent's arguments at paragraph 34 illustrates this point:

> Invoking the doctrine of exhaustion of local remedies, Respondent argues that this Tribunal cannot exercise the jurisdiction conferred upon it by NAFTA Chapter 11, because there has been litigation in the local courts and there are conflicting decisions on issues of Mexican law that only the local courts can resolve. In effect, Respondent is asking the Tribunal to cede jurisdiction over the dispute to domestic courts who have no competence to address the NAFTA issues that Claimant has placed before the Tribunal.

19. On the one hand, this Tribunal has not been vested with jurisdiction to decide matters of domestic law as if it were a Mexican court, even if local remedies have been exhausted. Only the Mexican courts have that jurisdiction. On the other hand, it is a settled rule of customary international law that local remedies must be exhausted in order for an international tribunal to admit a claim, even where it has been vested with jurisdiction over that claim. The Respondent will deal with each of these objections separately below.

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8. See Fiscal Court's decision in the 1998 case brought by CEMSA (concerning the October-December 1997 IEPS rebate denials and the 1998 amendment to the IEPS Law) cited at paragraph 235(c) of the Counter-Memorial, R 06322-23, and decision of the Fiscal Court in the 1996 Lynx case cited at paragraph 191 of the Counter-Memorial, CM 05984-05985. [The Respondent has continued the consecutive numbering system used for the exhibits to the Counter-Memorial; documents contained in the exhibit volume accompanying the Rejoinder are referenced beginning with "R" rather than "CM" so that they can more easily be located].

9. See paragraph 237 of the Counter-Memorial, R 06434-37 [pages 83-86 of the circuit court's 8 August 2000 decision]. The Circuit Court concluded that Article 2, section III of the IEPS Law complies with the principles of tax equality because it applies to all export activities, which is consistent with the reasoning of the Supreme Court's decision in the Lynx and CEMSA cases regarding the amendment to that Article in force during 1991. As opposed to the Supreme Court, however, which limited its analysis to that aspect only, the Circuit Court went on to analyze the consistency of Articles 4, section III (invoice requirements to state the IEPS expressly and separately) and 11 of the IEPS Law and concluded that they did not contravene the principles of tax equality, create a monopoly or in any way limit CEMSA's ability to export, even if the tax was not transferred and was therefore not entitled to the rebates.

A. The Tribunal is Not Authorized to Investigate Violations of Domestic Law

20. The Reply does not address the interaction between the Mexican judicial decisions and this international arbitration (other than to mischaracterize Mexico's arguments).

21. Whereas the alleged failure to implement the Supreme Court's ruling was relied upon as the central juridical fact in the Memorial, now that it has been shown that SHCP fully implemented the Supreme Court's ruling and that the Claimant's other arguments have been rejected by the Mexican courts, the Claimant now substantially downplays the role of the courts. (See the Reply at paragraphs 34-51).

22. This change in emphasis appears to have been prompted by the Circuit Court's decision on SHCP's appeal, and by the fact adduced by the Respondent (and not denied by the Claimant) that the Fiscal Court rejected the Claimant's arguments in another case brought by the Claimant to obtain rebates for exports made in late 1997, which was subsequently confirmed by a circuit court in an *amparo* proceeding.

23. The Reply deals with these two central facts only by saying that this is an international tribunal authorized to apply international not domestic law and the Tribunal ought not to give *res judicata* effect to the decisions of the "conflicting" Mexican court decisions[10].

24. Those decisions are not legally "in conflict", as one dealt with CEMSA's October-December 1997 applications for rebates that were denied and the 1998 amendment to the IEPS Law (referred to in the Counter-Memorial as the "1998 Fiscal Court proceeding"), while the other one dealt with SHCP's 1 March 1999 resolution covering the rebates that CEMSA obtained in 1996 and 1997 (referred to in the Counter-Memorial as the "1999 Fiscal Court proceeding"). Therefore, the Fiscal Court decision in the latter case has not "superseded" its decision on the former, as alleged by the Claimant at paragraph 39(4) of the Reply. It makes no difference whether the Fiscal Court acted in a Regional Chamber or in full. Both decisions are equal. Only appellate courts can supersede decisions of the lower courts.

25. When CEMSA filed for an *amparo* against the Fiscal Court's decision in the 1998 proceeding, rather than challenging the Court's findings that rejected its arguments concerning the October-December 1997 IEPS denials —as the Claimant now attempts to do before this Tribunal as a new and un-notified claim of denial of justice[11]— CEMSA simply sought to

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10. Reply at paragraph 45.

11. See Reply paragraph 39(3):

> "(3) the only appellate decision relied on by Respondent -- the Circuit Court opinion in the Consulta litigation (described further below) -- relies exclusively on the 1998 IEPS law, including particularly Article 11, as amended effective January 1, 1998. In doing so, the Court followed Hacienda's argument. The court did not address, and apparently did not appreciate, that the law changed in 1998. Respondent recognizes that there was no material change in the law from 1992-1997. (See, e.g., CM ¶ 4.) The opinion does not examine CEMSA's entitlement to rebates under the IEPS provisions in force in 1997.

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withdraw that part of its claim, after it had already been adjudged, and well over a year after it initiated the *amparo* proceeding. The Circuit Court did not allow it to do so, and the Fiscal Court's decision was confirmed.

26. In any event, in light of the Circuit Court's recent judgment concerning the Fiscal Court's 1999 proceeding, any alleged conflict has dissipated: there are holdings in two separate cases that the Claimant is not entitled to obtain IEPS rebates for cigarettes without having invoices with the tax separately stated and transferred.

27. The authority cited by the Claimant for the proposition that domestic court decisions are not *res judicata* for international tribunals, an ICSID Award in the case of *Amco Asia Corp.* v. *Indonesia*, requires more careful consideration than is given to it in the Reply[12]. As pointed out in the Counter-Memorial, under Article 42 of the ICSID Convention, ICSID tribunals have a domestic law jurisdiction as well as an international law jurisdiction. This was confirmed by the second ICSID Tribunal on the re-submitted case in *Amco* (the award cited by the Claimant was the first award which was subsequently annulled), where it commented:

> In any event, the Tribunal believes that its task is to test every claim of law in this case first against Indonesian law, and then against international law [13].

28. In addition, the point of Indonesian law dealt with by the ICSID Tribunal was not the same point considered by the Indonesian Supreme Court. The issue for the original ICSID Tribunal was whether an Indonesian Supreme Court decision which evaluated an armed take-over of the hotel complex was *res judicata* on a point of Indonesian law for the international tribunal considering a different point of international law. After quoting the Indonesian Supreme Court, the Tribunal pointed out:

> It follows from this formulation that the Supreme Court did not legitimize the April 1 take-over of the hotel but on the contrary based its decision on the very same factual situation –the seizure—without expressing any legal evaluation of this act. This is not a legitimization of [the government entity's] behavior in connection with the take-over [14].

29. As this passage shows, the ICSID Tribunal was not presented with the situation that is before this Tribunal. Here, the domestic courts have spoken specifically on the domestic legal rights and the Tribunal is being invited to substitute its views of domestic law for that of the

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> Therefore, the decision is not dispositive on that issue. Moreover, a decision denying rebates due for 1997 exports by applying a different standard, found in legislation applicable to a later time frame, constitutes a denial of justice under international law and should be disregarded by the Tribunal...."

12. See the Counter-Memorial at paragraph 42 for a discussion of this point.

13. Re-submitted Case: Award, 1 ICSID Reports 569 at paragraph 40, p. 580.

14. *Amco Asia Corporation and Others* v. *The Republic of Indonesia*, 1 ICSID Reports, Initial Award 413 at paragraph 175, p. 459. Note also the Tribunal in the re-submitted case carefully studied the Supreme Court's decision (at paragraph 152).

courts. Moreover, the Claimant is advancing the same arguments to this Tribunal that were advanced to and rejected by the domestic courts.

30. There is no international legal right to IEPS rebates; it is purely a question of domestic law, subject to the jurisdiction of the domestic courts and, as it has previously held, this Tribunal is not granted a domestic law jurisdiction.

31. International tribunals regularly and properly defer to the decisions of domestic courts on matters of domestic law. As this case is premised upon the Claimant's claimed entitlement to tax rebates under domestic law, the decisions of the courts on its claimed entitlement are important for two reasons:

- First, if CEMSA did not have the "right" at domestic law that it claims was expropriated, there can be no expropriation at international law.
- Second, this Tribunal should accept the determinations of the domestic courts on domestic rights unless, as the *Azinian* Tribunal put it, the courts themselves are disavowed: "A governmental authority surely cannot be faulted for acting in a manner validated by its courts unless the courts themselves are disavowed at the international level"[15].

32. The *Azinian* Tribunal also stated:

> 98. True enough, an international tribunal called upon to rule on a government's compliance with an international treaty is not paralysed by the fact that the national courts have approved the relevant conduct of public officials...[the Tribunal then cites the former president of the International Court of Justice, Eduardo Jiménez de Arechaga in this regard]
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> ...
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> 99. The possibility of holding a State internationally liable for judicial decisions does not, however, entitle a claimant to seek international review of the national court decisions as though the international jurisdiction seized has plenary appellate jurisdiction. This is not true generally, and it is not true for NAFTA. *What must be shown is that the court decision itself constitutes a violation of the treaty.* Even if the Claimants were to convince this Arbitral Tribunal that the Mexican courts were wrong with respect to the invalidity of the Concession Contract, this would not per se be conclusive as to a violation of NAFTA. More is required; the Claimants must show either a denial of justice, or a pretence of form to achieve an internationally unlawful end. [Emphasis in the original]

33. The observations of Eduardo Jiménez de Arechaga, to whom the *Azinian* Tribunal referred, is apposite to this Tribunal's examination of the domestic law issues:

> It is not for an international tribunal to act as a court of appeal or of cassation and to verify in minute detail the correct application of municipal law. The essential business of an international tribunal in these cases is to see whether gross injustices have been committed against an alien and, if so, whether the three indicated requirements are

15. See paragraph 285 of the Counter-Memorial.

present. The angle of examination is different from that of an appeal judge: it is not the grounds invoked by the domestic tribunal which must be scrutinized, but rather the result of the decision which must be evaluated, taking into account the elements of justice and equitable consideration[16].

34. The learned author points out that only in the most exceptional circumstances would a decision by a domestic court that is contrary to domestic law be found to be contrary to international law. The three cumulative requirements to which the passage quoted above refers are: (i) the decision had to be a "flagrant and inexcusable violation of municipal law", (ii) it had to be a decision of a court of last resort, all remedies available having been exhausted, and (iii) a subjective factor of bad faith and discriminatory intention on the part of the courts had to have been present[17].

35. The decisions of the domestic courts in this case do not contain any of the three requirements. Until the Reply, no suggestion was even made that the Claimant suffered a denial of justice before the Mexican courts[18]. CEMSA's claim to IEPS rebates and its compliance with the IEPS Law in terms of record-keeping, over-claiming the IEPS, exporting to fictitious companies, *etc.*, was fully disputed in the domestic courts. There was no allegation that there was a "flagrant and inexcusable violation of municipal law" by the highest court, that all remedies were exhausted, and that a subjective factor of bad faith and discriminatory intention on the part of the courts was present[19].

36. For the first time, at paragraph 39(3) of the Reply, the Claimant alleges that the Circuit Court's decision upholding the Fiscal Court's decision in the 1998 proceeding "constitutes a denial of justice under international law and should be disregarded by the Tribunal".

37. The Respondent objects to this claim as inadmissible. This court decision –addressing an appeal from the Fiscal Court's review of the enforcement of a taxation measure—is covered by Article 2103. Accordingly, no Article 1105 claim for denial of justice can be advanced.

38. Moreover, even if it was admissible, it is a measure of the weakness of this new argument that in one sentence, with no argument in support of the proposition, the Reply would attempt to convert the Circuit Court's decision into a denial of justice at international law. No attempt was made to address the strict requirements set out by Jiménez de Arechaga and the other authorities. Nor can this new allegation be reconciled with the statement to opposite effect made a page later in the Reply at paragraph 41, that "the Article 1110 claim in this case is not based upon Mexico's responsibility for the acts of its judiciary".

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16. Eduardo Jiménez de Arechaga, "International Law in the Past Third of a Century", 159 Receuil des Cours I, p. i at p. 282.

17. Ibid at p. 281.

18. This may be because the case that is alleged to have resulted in a denial of justice was not brought to the Tribunal's attention by the Claimant.

19. Indeed, at paragraphs 34-38 of the Reply, the Claimant argues that there is no need to exhaust local remedies.

39. In any event, the Reply's description of what the Circuit Court did in upholding the Fiscal Court is incorrect. The Fiscal Court rejected all of CEMSA's arguments and the Circuit Court confirmed the Fiscal Court's decision in respect of those issues that were challenged by CEMSA in the *amparo* proceeding. As explained above (see paragraph 25), CEMSA did not challenge the substance of the Fiscal Court's findings as they applied to the October-December 1997 rebate denials. Rather, CEMSA sought before the Circuit Court only to withdraw that part of its claim after the claim had been adjudged by Fiscal Court and over a year after it initiated the *amparo* proceeding[20]. The Circuit Court rejected CEMSA's attempt to withdraw a claim after it had already been ruled on, but made no decision as to the merits, because it was not an issue otherwise brought to its attention by CEMSA. The Claimant is making those arguments for the first time in these proceedings.

40. The Claimant also argues that there was no effective legal remedy under Mexican law[21]. This, with respect, is unsound in law and principle. If the Claimant's court challenges failed, it is incorrect to say that there is an absence of an effective legal remedy just because he lost.

41. If that were true, every disappointed litigant who otherwise met the standing requirements of Section B of Chapter Eleven would have a claim for an alleged breach of international law.

42. The Tribunal should also note that the Claimant concedes at paragraph 45 of the Reply that "The case might be otherwise if there were a Mexican Supreme Court decision supporting the Respondent's position...". In fact, there is a circuit court decision that determined that the Claimant was not entitled to obtain IEPS rebates for exports of cigarettes without having invoices with the tax separately stated and transferred. The circuit courts are the highest appellate courts in cases of this type, and their decisions cannot be further reviewed, even by the Supreme Court of Justice. Thus, they are not hierarchically inferior to a decision of the Supreme Court, as suggested in the Reply, but rather of the same level: they are all final decisions of the highest appellate court. The Tribunal should also bear in mind that, as noted by the Circuit Court in the 8 August 2000 decision regarding the 1998 Fiscal Court proceeding, the circuit court decisions are not inconsistent with the Supreme Court's reasoning[22].

43. The reason why the 1991 *Lynx* and *CEMSA* cases ended up in front of the Supreme Court on appeal and the Fiscal Court cases ended up in front of a circuit court is the operation of the Mexican judicial system: Usually, challenges of the constitutionality of a law (such as Article 2, section III of the IEPS Law in force in 1991) are reviewed by the Supreme Court on appeal, while acts of administrative authorities are regularly reviewed by circuit courts. In any event, the Supreme Court cannot review a decision of a circuit court on appeal because these are alternative, not successive, appellate proceedings.

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20. The Fiscal Court rendered its decision on 24 November 1998. CEMSA filed an *amparo* action on 2 March 1999. The Circuit Court admitted CEMSA's *amparo* challenge on 29 April 1999. On 15 June 2000 the Claimant, acting on behalf of CEMSA, sought to withdraw the arguments it had made before the Fiscal Court concerning the October-December 1997 IEPS rebate denials. The Circuit Court rendered its decision on 8 August 2000.

21. Reply at paragraph 40.

22 As already stated, the 16 January 2000 decision of the Fiscal Court is still *sub judice*.

B. The Exhaustion of Local Remedies Rule

44. The Reply contends that the NAFTA eliminates any obligation to exhaust local remedies (at paragraph 45), because it is incompatible with the waiver requirement regarding damages claims in Article 1121 (at paragraph 37) and it contradicts the purpose of Section B of Chapter Eleven to provide due process before an impartial tribunal (at paragraph 36).

45. As already noted, NAFTA Article 1131 requires the Tribunal to decide the issues in dispute in accordance with the NAFTA and applicable rules of international law. The applicable rules of international law include the local remedies rule, a well-settled principle of customary international law (see Counter-Memorial paragraphs 369-378). In the absence of express language in the NAFTA eliminating that rule, it cannot be presumed that the NAFTA Parties so agreed[23].

46. As the Reply correctly points out (at paragraph 34), the waiver required by Article 1121 is limited to damages claims. The Claimant filed such a waiver with his Notice of Claim on 30 April 1999. He did not discontinue litigation initiated prior to that date and, to the Respondent's knowledge, he has not to sought to bring damages claims with respect to the measure alleged to be a breach of the Section A in any other forum.

47. Moreover, the waiver filed by the Claimant has not precluded him from litigating before the domestic courts in order to assert his rights under Mexican law. Indeed, CEMSA filed an action in the Fiscal Court challenging the rebate denials by SHCP for the months of October through December 1997 and January 1998, as well as SHCP's 24 February 1998 resolution in response to CEMSA's inquiry of 12 December 1997, and subsequently initiated an *amparo* proceeding before a circuit court on 22 March 1999. Also, on 28 April 1999, just before presenting the required waiver in this proceeding, the Claimant, on behalf of CEMSA, filed an action in the Fiscal Court challenging SHCP's 1 March 1999 resolution, and subsequently initiated an *amparo* proceeding on 6 September 2000. The Claimant did not discontinue any proceedings in the domestic forum nor did he refrain from initiating other proceedings with respect to the measure alleged to be a breach of Chapter Eleven Section A.

48. The Respondent did not object, because such actions were not affected by the waiver given in this proceeding (the Claimant has also not sought to submit an alleged breach of the NAFTA to the Mexican courts, so there is no conflict with Annex 1120.1). The 1999 Fiscal Court proceeding is still *sub judice*[24], as acknowledged by the Claimant at paragraph 48 of the Reply.

49. The Claimant's actions before the competent Mexican courts were not "temporary" as now alleged at paragraph 39(2) of the Reply, and the Claimant's pursuit of domestic remedies demonstrates that, whatever his motives were for "seeking to terminate both litigations" (Reply at paragraph 39(3)), they were unrelated to the waiver granted pursuant to Article 1121.

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23. See the judgment of the International Court of Justice quoted at paragraph 374 of the Counter-Memorial.

24. Third Witness Statement of Eduardo Díaz Guzmán, at paragraph 4.

50. In fact, the Claimant has not really sought to withdraw from the domestic proceedings: As explained above, CEMSA only sought to withdraw part of its claim in the *amparo* concerning the 1998 Fiscal Court proceeding after the court ruled against it. As for the 1999 Fiscal Court proceeding, in respect or which he now claims that it "could be withdrawn if the Tribunal awards the relief requested"[25], the Tribunal should note that the Claimant cannot now withdraw from an appeal brought by SHCP in a case originally instituted by CEMSA. The Tribunal should also note that CEMSA has not withdrawn from the *amparo* proceeding initiated by CEMSA in connection with the same decision of the Fiscal Court.

51. In any event, because such domestic proceedings are the appropriate remedy in order to determine the Claimant's and CEMSA's legal status under Mexican law, and because they are in no way affected by the waiver granted in this proceeding, there is no reason for the Claimant to withdraw from them.

C. The New "Creeping Expropriation" Claim

52. The Reply's attempt to salvage the creeping expropriation claim should be rejected. At paragraph 149 of the Memorial, the Claimant expressly described a list of "measures" which were alleged to be inconsistent with the NAFTA.

53. Of the seven listed measures in paragraph 149, only two ((a) and (c)) were notified to the competent authorities as alleged expropriations under Article 2103(6). They are properly before the Tribunal.

54. The Reply now states that the "creeping expropriation" is not a "measure" (see paragraph 28) but rather it is a "characterization of a measure". Yet having said that, footnote 12 of the Reply then states the opposite:

> The phrase "creeping expropriation" applies more precisely to the intermittent measures taken against CEMSA in 1991 and 1993-1996, which culminated with the final termination of its cigarette business. [Emphasis added]

55. The measures notified to the competent authorities did not include "intermittent measures taken against CEMSA in 1991 and 1993-1996, which culminated with the final termination of its cigarette business". Rather, as the Notice of Intent to Submit a Claim plainly indicates, the two measures (other than the 1998 amendment to the Law) were the alleged failure to comply with the Supreme Court's ruling and the denial of IEPS rebates for October-December 1997.

56. Footnote 12 makes it clear that the Claimant is still trying to raise an un-notified expropriation measure (or "intermittent measures") claim in this proceeding without complying with Article 2103(6).

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25. Reply at paragraph 48.

57. At paragraph 28, the Reply speaks of the "detailed arguments [that CEMSA] made to the U.S. Treasury Department over several months". The Claimant admits at footnote 13 that "we do not know how much of claimant's position was shared with Hacienda."

58. The Claimant filed a copy of his Notice of Intent with the *Subsecretario de Ingresos* (Lic. Tomás Ruiz González) on 16 February 1998. He later delivered a copy of the Notice of Intent to the Assistant Secretary (Tax Policy) of the U.S. Department of the Treasury. According to the plain language of Article 2103(6), the competent authorities consult over the measures identified in the Notice of Intent to Submit a Claim to Arbitration given under Article 1119, not the "detailed arguments" that the investor might have raised with its own Party. The authorities examine the measures listed in the Notice. They then agree or disagree as to whether the impugned measures are not an expropriation. If they do not agree that a particular measure cannot be an expropriation, the measure can be considered by a tribunal.

59. It matters not what the Claimant may or may not have said separately to the U.S. Treasury Department[26]. The only instrument of jurisdictional significance to this Tribunal is the Notice of Intent to Submit a Claim to Arbitration.

60. The Respondent reiterates its objection to this attempt to inject an un-notified expropriation claim into this proceeding. Mexico does not consent to the consideration of any allegation of creeping expropriation.

61. The Respondent also notes that there appear to be two new claims added in the Reply (see paragraphs 31 and 39). For the record, the Respondent objects to the consideration of either claim.

D. The Relief Sought in Respect of the 1996-1997 Rebates Paid to CEMSA

62. The Claimant now asserts that he has submitted "an incidental or additional claim respecting the audit and tax assessment in his Memorial" under Article 48 of the Arbitration (Additional Facility) Rules, which he contends "has been fully documented and is ripe for decision", the issues and evidence being the same as those in the "original" claim.

63. The Respondent has already dealt with the Tribunal's jurisdiction to grant injunctive relief or contingent damages in detail in its Counter-Memorial, and will not address it further here, except as follows.

64. To the extent that this new "incidental or additional claim" is one for expropriation, it has not been referred to the competent taxation authorities for determination pursuant to NAFTA Article 2103(6). Moreover, it cannot be so referred under Article 2103(6), because the "measure" complained of has not occurred. The Claimant has challenged the 1 March 1999 SHCP resolution, and there is no final determination in respect of the Claimant's or CEMSA's

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26. In any event there is no evidence of such communications in the record of this proceeding.

rights and, for the same reason, on what measures SHCP may take in that connection. As already noted by the Respondent and admitted by the Claimant, the issue is still *sub judice*.

65. To the extent that the new "incidental or additional claim" is one of breach of Article 1105, it must also be dismissed because, as already stated, Article 1105 does not apply to taxation measures.

66. As opposed to dispute settlement under Chapter Twenty[27], which allows claims concerning proposed (*i.e.*, future) measures, Chapter Eleven only applies to "measures adopted or maintained by a Party" (see Article 1101).

67. Thus, the conditions established in Articles 1119, 1120 (including a lapse of six months from the events giving rise to the "new" claim), 1121, 1122 and 2103(6) have not been satisfied, and cannot be satisfied at this time. The new claim must therefore be dismissed.

III. STATEMENT OF FACTS

68. The Respondent responds to the Reply's allegations of fact as follows.

A. The Sectoral Registry

69. The Claimant contends at paragraph 5 that:

> CEMSA has been barred from exporting cigarettes since December 1, 1997 by Hacienda's refusal to rebate IEPS taxes and from mid-1998 by Hacienda's refusal to enroll CEMSA in its sectoral registry for cigarettes and alcoholic beverages.

70. As explained in the Counter-Memorial (at paragraphs 96 and 227), denial of registration in the Sectoral Exporter's Registry is no bar to CEMSA's export or other activities. Registration is only required in order to benefit from the application of the 0% IEPS rate. The Circuit Court that reviewed the 1998 Fiscal Court's decision stated to this effect:

> There is no violation to Constitutional Article 5 [which establishes the right of any person to engage in any licit professional, industrial, trade or labor activity] because in this case nothing precludes the claimant from engaging in the activity of its choice; however, every activity must be regulated by specific laws issued to that effect. In this sense, if the

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27. See NAFTA Article 2004 (Recourse to Dispute Settlement Procedures)

> "Except for the matters covered in Chapter Nineteen (Review and Dispute Settlement in Antidumping and Countervailing Duty Matters) and as otherwise provided in this Agreement, the dispute settlement provisions of this Chapter shall apply with respect to the avoidance or settlement of all disputes between the Parties regarding the interpretation or application of this Agreement or wherever a Party considers that an actual or proposed measure of another Party is or would be inconsistent with the obligations of this Agreement or cause nullification or impairment in the sense of Annex 2004." [Emphasis added]

> interested party complies with the guidelines established by a regulation in order to be able to engage in the profession, industry, trade activity or work of choice, it may do so. In this case, nothing precludes the claimant from carrying out whatever work it has chosen, and this is in fact so that the claimant itself declares that it exports processed tobacco that it purchases from Sam's and Price Club, which is also assumed in light of the copies of pediments in the record of the fiscal proceedings; it must be presumed, therefore, that the legal provision in question is not breached. Moreover, the articles that it claims are unconstitutional [a reference to articles 4 and 11 of the IEPS Law] do not impose any restriction on the claimant's activities; since they only refer to the special tax on production and services, and not to a requirement that would be impossible to comply with in order to export its products.[28]

71. At paragraphs 5-6 the Reply emphasizes SHCP's registration of Mercados Extranjeros, S.A. de C.V. (referred to as Mercados II in the Memorial and Reply) in the Sectoral Registry of Exporters. This is taken as an authorization to Mercados Extranjeros to apply for and obtain IEPS rebates on exports of cigarettes.

72. Under Article 19 of the IEPS Law, registration in the Sectoral Registry is required in order to be entitled to apply the 0% IEPS rate on exports. It is a necessary but not sufficient requirement for obtaining IEPS rebates. Registration does not mean an automatic entitlement to IEPS rebates. All other requirements must be complied with.

73. Proof of that is shown by comparing Lic. Obregón's recommendations in the case of both CEMSA and Mercados Extranjeros. Lic. Obregón's memorandum to Lic. Simón Vargas Aguilar of 20 March 2000 recommended that Mercados Extranjeros not be registered because certain irregularities were detected. Lic. Obregón explains in his witness statement that he later became aware that Mercados Extranjeros had complied with its obligations and that at that time was incorporated in the Sectoral Exporters Registry[29].

74. In the case of CEMSA, the situation was the same: in his response to Lic. Simón Vargas Aguilar dated 1 September 1999 concerning CEMSA's application, Lic. Obregón noted that CEMSA had fiscal obligations that it had not yet complied with and recommended that it not be registered "until such time as it has complied with all its fiscal obligations"[30]. CEMSA, however, has not satisfied its pending legal obligations. Rather, to date, the Claimant has chosen to litigate, both in domestic and international *fora*.

75. Thus, Mr. Obregón's recommendation in both cases was the same, except that Mercados Extranjeros cured its irregularities and CEMSA has not done so. C.P. Gabriel Oliver's statement is consistent. He notes that once the audit for fiscal years 1996 and 1997 had been concluded, in accordance with rule 6.2.3 of the Foreign Trade Miscellaneous Resolution it was recommended

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28. [R 06433-34] [pages 82-83 of the Circuit Court's decision of 8 August 2000.

29. Witness statement of Lic. Rafael Obregón Castellano, paragraphs 58-62, CM 06119-06120.

30. CM 05348.

not to incorporate the taxpayer in the registry until such time that it was in compliance with all of its tax obligations[31].

76. Under the IEPS Law after 1998, if a cigarette re-seller, including CEMSA, were to buy directly from a producer, in a first-hand sale, the IEPS could be transferred expressly and separately, and the reseller therefore could satisfy the necessary requirements to obtain rebates. Neither Lic. Obregón nor other SHCP officials had reason to prejudge whether resellers such as Mercados Extranjeros or CEMSA could meet the applicable conditions. As far as Lic. Obregón was concerned, CEMSA could have been registered too, but was not due to the existence of irregularities.

77. Furthermore, of the taxpayers that Lic. Eduardo Díaz Guzmán declares applied for and obtained rebates and that required registration in the Sectoral Registry after 1998, all have been or currently are being investigated. One has been assessed and the in the other two cases the respective assessments are pending (the taxpayers are not "subject to future review", as the Reply suggests at paragraph 13). This shows that CEMSA has been treated no less favorably than other taxpayers that are in like circumstances.

B. The Alleged Overpayment of Lynx Exportadora S.A. de C.V.

78. At paragraph 19 of the Reply, the Claimant alleges that SHCP entered into a "large and controversial settlement" with Lynx whereby it over-paid Lynx by "nine times the amount ordered by the Court with respect to LYNX's 1992 Supreme Court *amparo* decision –more than 27 million pesos (about U.S. $3 million)", and cites the supplementary witness statement of CEMSA's/Lynx's lawyer, Lic. Enríquez. (The Memorial (at paragraph 78) originally contended that such settlement was made in connection with the 1996 Fiscal Court decision.)

79. There was no settlement entered into by SHCP and Lynx, either in respect of the 1996 Fiscal Court decision or the 1992 Supreme Court decision. SHCP paid rebates to Lynx in strict compliance with the respective judicial decisions. There was no overpayment; the calculations were all subject to detailed judicial scrutiny. There is no evidence of wrong doing on the part of any SHCP official.

80. The payment of rebates to Lynx in connection with the 1996 Fiscal Court decision is explained at paragraphs 189-191 of the Counter-Memorial. As stated by Lic. Eduardo Díaz Guzmán in his third witness statement[32], the assessment of rebates owed for exports of alcoholic beverages in 1991 in connection with the 1992 Supreme Court decision was done by applying the provisions of the Fiscal Code strictly in accordance with two decisions that followed that of the Supreme Court in 1992 that resolved the Lynx *amparo*: (1) one by the District Judge that resolved a complaint (*queja*) filed by Lynx concerning compliance with the 1992 Supreme Court decision regarding the proper methodology for calculating the adjustments for inflation, since

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31. Witness statement of Gabriel Oliver García, paragraphs 32-38, CM 06004-06006.

32. Third Witness Statement of Lic. Eduardo Díaz Guzmán [R 06453-54].

Lynx disagreed with how SHCP had calculated rebates in 1993 in the amount of N$8,709,371[33]; and (2) another one by the Supreme Court that resolved a complaint on the former complaint (*queja de la queja*) filed by the *Procurador Fiscal de la Federación* challenging the District Judge's *queja* decision in respect of the methodology for calculating the interest accrued[34]. As noted in an official letter from the Federal Treasury to the *Procuraduría Fiscal de la Federación*, on 5 December 1996 SHCP paid Lynx 27,011,322 pesos in compliance with the above mentioned judicial decisions. The result is obtained from adjusting for inflation to December 1996 the favorable balance obtained by Lynx in 1991, calculated in accordance with the District Judge's *queja* decision, plus interest, calculated in accordance with the Supreme Court's *queja de la queja* decision[35].

C. The Ultimate Destination of the Cigarettes Shipped to the United States

81. The Tribunal will recall that as part of its initial defense, the Respondent tendered the witness statement of Mr. Rolando García. Mr. García took all of the available documents pertaining to CEMSA's sales and prepared the large color charts showing the various parties involved in CEMSA's sales and the ultimate destination of the cigarettes, including those sent to the United States[36].

82. Table 2 showed that 98% of CEMSA's exports to the United States ended up in the same warehouse in El Paso, Texas, even though they were shipped to six different companies.

83. The Counter-Memorial then suggested (at paragraph 435) that:

> The available evidence points to the possibility that the cigarettes were shipped back to Mexico.

84. The Reply castigated the Respondent for suggesting that this is what may have occurred. Calling this "pure speculation", the Reply stated:

> 22. In fact, there is no evidence whatsoever connecting Claimant with any possible shipment of cigarettes to Mexico.

85. The Respondent disagrees. There was substantial circumstantial evidence filed with the Counter-Memorial connecting the Claimant's exports with the likely shipment of cigarettes to Mexico. However, in view of this issue's relevance to the national treatment and public policy issues, the Respondent has obtained a sample of the U.S. Customs Service forms relating to the cigarettes when they exited the United States.

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33. App. 0947 to the Memorial.
34. App. 0970 to the Memorial.
35. R 06439 [Letter of 28 March 2000].
36. See Table 2 attached to his statement.

86. It can now be confirmed that the cigarettes did indeed go back into Mexico. Rejoinder Exhibit 1 contains Form 7512s filed with U.S. Customs Service as well as various instructions to Kintetsu World Express from Mr. Eduardo Silva of J & E International Sales, Inc.[37].

87. In addition to receiving cigarettes directly from CEMSA, J & E was the party who ultimately received the balance of the cigarettes CEMSA shipped to the United States, regardless of whether the CEMSA invoice listed Lynx Exportadora, Compañía Exportadora Mexicana, International Commerce Co., GTO Produce, or GTO International Trade as the customer.

D. The Allegation Concerning "Mexican authorities" Repeatedly Ignoring Adverse Judicial Decisions", and the Evidence of Lic. del Río

88. The Claimant's arguments in the Memorial and at paragraph 40(2) of the Reply concerning Mexican authorities' allegedly ignoring adverse decisions and the evidence of Lic. del Río are immaterial to his case. Lic. del Río's comments center on the following points:

- The instances and number of cases that Mexican authorities allegedly fail to comply with judicial decisions in *amparo* proceedings.

  The Respondent has shown that SHCP promptly and fully complied with the 1993 Supreme Court decision and all other decisions referred to by the Claimant. Whatever the merits of Lic. del Río's evidence may be, it is, with respect, completely beside the point. However, with regard to the first question posed to Lic. del Río by the Claimant on the number of incidents initiated by private litigants concerning non-compliance with *amparo* decisions, the Tribunal should note that the Claimant did not initiate such an incident with respect to SHCP's compliance with the 1993 Supreme Court decision. Rather, it expressly agreed that SHCP had fully complied.

- The alleged amendment to laws in order to avoid compliance with judicial decisions.

  The Claimant's other expert, Lic. Loperena, has testified that the IEPS Law did not change in any material respect between 1992 and 1997. The Respondent concurs. The 1993 Supreme Court decision was fully complied with as early as April 1994. Lic. del Río's comments in this respect are, therefore, also immaterial. Nevertheless, it should be pointed out that there is nothing wrong in amending an unconstitutional provision. Article 2, section III of the IEPS Law was amended by Congress over a year before the 1993 Supreme Court's decision. The constitutionality of the amended provision was later affirmed by the Circuit Court in its 8 August 2000 decision regarding the 1998 Fiscal Court proceeding[38].

- Lic. del Río's opinion on the hypothetical case presented to him by the Claimant.

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37. See Rejoinder Exhibit 1.

38. [R 06431] [page 108].

There is a complete and detailed record of the *amparo* initiated by CEMSA in respect of the 1991 amendment to the IEPS Law so, with respect, Lic. del Río's comments on the hypothetical case are also completely irrelevant. It is telling, however, that the Claimant chose to present him with a hypothetical case rather than ask him to opine on the actual record of CEMSA's case.

E. The Claimant's Evidence That SHCP Was Under An Obligation to Force Producers to Issue Invoices With the IEPS Expressly Transferred and Stated Separately

89. The Claimant's expert, Lic. Loperena, has testified that SHCP was under an obligation to force producers to issue invoices expressly transferring the tax and stating it separately. His evidence, however, is contradicted by the Claimant's own arguments before the Mexican courts.

90. In the *amparo* initiated against the 1998 decision of the Fiscal Court, the Claimant asserted:

> Indeed, it is not until the time that it exports the goods that the claimant in the *amparo* is under an obligation to pay the special tax on production and services and legally becomes a taxpayer of such tax, so prior to that circumstance actually taking place, it has no right to request the express and separate transfer of the tax, because logically and chronologically, prior to exporting it is not a taxpayer of the tax on the goods in question.
>
> Moreover, as has already been pointed out, the claimant cannot request its suppliers [Sam's Club] to expressly and separately transfer the tax in question [the IEPS on cigarettes] because it does not acquire said goods [cigarettes] directly from the producers, and the only ones that have a duty to issue such invoices are those obligated to pay the tax, and the suppliers referred to lack such characteristics.
>
> Furthermore, even assuming that its [CEMSA's] suppliers had transferred the tax to the claimant for its purchases of processed tobacco, it would not be able to credit the tax so transferred because such suppliers are not taxpayers of the tax that is alluded to. [39]
>
> [Emphasis added]

91. Thus, the Claimant's position before the Mexican courts was that CEMSA's suppliers had no right to request invoices with the tax expressly transferred and stated separately, because they were not taxpayers (CEMSA only became a taxpayer upon exporting).

92. In fact, Lic. Loperena's —and the Claimant's— arguments are inconsistent with each other. Lic. Loperena has testified:

> ...a taxpayer such as CEMSA is not required to perform requirements that are impossible for it to perform because of the non-feasance [sic] of other parties such as the producers. There is the Latin principle 'Ad imposibiliam nemo tenetur' (Nobody is obliged to the

39. [R 06400-01] [pages 48-49].

> impossible). This is particularly true where, as here, the requirement is administrative, not substantive. The right of a taxpayer to obtain rebates cannot depend on the sole will of a third party in general. In particular it is more clear [sic] when such party is a competitor of the taxpayer. If the law grants a right to certain individuals, the right must not be subject to the decision of another individual who impairs the right and is the interested party to deprive the other from said right. [40]

93. Yet, if "SHCP was empowered by the law to compel third parties to comply with the applicable legislation", *i.e.*, with the obligation to issue invoices expressly transferring the IEPS and stating it separately, and "[o]nce the SHCP was aware of these refusals [to provide such invoices] it must had [sic] acted in order to enforce the above mentioned provision", then it would not have been "impossible" for CEMSA to obtain the required invoices[41].

F. The Alleged 1995 "Oral Agreement"

94. The Claimant has simply submitted one page from a letter that he claims to have sent to Undersecretary Tomás Ruiz, where he makes reference to the alleged 1995 "oral agreement". That single page proves nothing other than the Claimant himself made reference to a "previous agreement of the SHCP and in compliance with the judgment of the Supreme Court of the Nation 1241/91". Lic. Heftye has referred to this type of communication presented by the Claimant in late 1994 and 1995 (see paragraph 169 of the Counter-Memorial).

95. The Respondent addressed this issue extensively in the Counter-Memorial. It will only reiterate that the law is clear as to what type of resolutions by SHCP create rights for taxpayers, and the effects of those rights. The Mexican courts have expressly rejected CEMSA's arguments that SHCP's actions in making the 1996-1997 payment of rebates constituted a favorable resolution and thus created an entitlement to future rebates. Thus, an alleged "oral agreement" and vague references to such an agreement in his own communications also fall far short of giving the Claimant a legal right to rebates under Mexican law.

G. Other Allegations Made in the Reply

96. The Respondent wishes to correct the record and refer briefly to other allegations made in the Reply.

- At paragraph 53 the Claimant states that the Respondent declines to admit that CEMSA exported cigarettes in 1992. The Respondent in fact admitted that CEMSA exported cigarettes in 1992. It simply said that it is unable to confirm or deny that CEMSA obtained IEPS rebates for such exports, as SHCP no longer has the pertinent records. Under internal guidelines, SHCP keeps records for a period of five years, after which they are regularly destroyed (Counter-Memorial at paragraph 144);

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40. First Opinion of Carlos Loperena Ruiz, at page 22.

41. Second opinion of Carlos Loperena Ruiz, at page 1.

- At paragraph 54 the Claimant contends that the "Respondent insinuates at several points —but does not state— that Hacienda suspended IEPS rebates to CEMSA in October - November 1997 because of the 1996 financial statements it received on September 29, 1997" and that "[t]his insinuation is misleading". In fact, the Respondent has asserted that in October 1997, after reviewing the information contained in CEMSA's financial statements for 1996, filed with SHCP on 27 September 1997, "SHCP officials began a review of CEMSA's applications. Since the IEPS rebates claimed involved cigarettes, SHCP had reason to assume that it did not have a right to obtain them. Accordingly, further rebates to CEMSA were suspended in order to investigate its operations" (Counter-Memorial at paragraphs 216-227).

- At paragraph 55 the Claimant contends that "Respondent simply refuses to acknowledge that it changed its policy towards CEMSA in October 1997 at the request of Carlos Slim. All decisions concerning IEPS rebates on CEMSA's cigarette exports, including the decision to terminate the 1995 audit, were made at high levels Mem. ¶¶ 53-64, 67-68, 80), and Respondent's assertion that audits "in no case . . . involve higher levels within SHCP" (CM ¶ 177 (b)) is contradicted by its own evidence. (CM ¶¶ 240-241.)" The Respondent denies that it changed its policy at the behest of Carlos Slim, and has addressed this issue at length. The quote taken from the Counter-Memorial is out of context. The full sentence at paragraph 177(b) of the Counter-Memorial from which a few words were quoted by the Claimant shows that it refers only to the 1995 audit: "The [1995] audit was accordingly terminated on procedural grounds in accordance with pre-existing rules, where the decisions lie with the responsible authority and in no case do they involve higher levels within SHCP". Paragraphs 240 and 241 of the Counter-Memorial referred to by the Claimant as contradicting evidence, refer to the 1998 audit. There have been many decisions in this case by SHCP officials. The Respondent clearly indicated who made them.

- At paragraph 56 the Reply asserts that "both Cigatam and Philip Morris fought hard to maintain the trademark owners' exclusive control over exports from Mexico. (Salazar Stmt. ¶ 15, CM 06080; Gomez Gordillo Stmt., ¶ 36, CM 06054-55) and that Respondent supported that effort by withholding IEPS rebates from CEMSA contrary to the 1993 Supreme Court decision". The Respondent has addressed these points concerning exports by Cigatam, the alleged export monopoly and the effects of the 1993 Supreme Court decision. It will only say further that, as testified by Lic. Gómez Gordillo, CEMSA and the Claimant did not have an exclusive right to approach SHCP to lobby their interests; others, including Cigatam, did too. Cigatam's reasons are stated in a letter from Michael B. Adams to the Claimant (App. 297-99 to the Memorial).

IV. RESPONSE TO THE SURVIVING CLAIMS: STATEMENT OF THE LAW ON THE MERITS

A. Response to the Allegation That Mexico Failed to Comply With the Ruling of the Supreme Court and Thereby Violated Article 1110 of the NAFTA

97. There is little discussion in the Reply of SHCP's compliance with the 1993 ruling by paying back the rebates claimed. There is no response to the fact that SHCP informed the District Judge of the need for invoices that separately stated the IEPS or that CEMSA provided them (and that they related to alcoholic beverages, not cigarettes).

98. The Reply's admission to paragraph 121 of the Counter-Memorial is telling. That paragraph had stated that "[a]ll of the invoices were for purchases of beer and alcoholic beverages, not cigarettes". The Claimant admitted the former (namely, "[a]ll of the invoices were for purchases of beer and alcoholic beverages") but not the latter. Yet the former admission encompasses the latter denial; it indicates that all of the invoices submitted for IEPS rebates were for non-tobacco related products.

99. The Reply also admits at paragraph 43 that:

> It may be that the Court did not review the "mechanics" of the IEPS Law...

100. This admission is correct. The Supreme Court's ruling concerned a question of status, not the mechanics of entitlement in light of concrete facts. It did not consider the operation of Article 4 of the IEPS Law. SHCP's insistence upon compliance with Article 4 was the application of a pre-existing, reasonable, non-discriminatory procedure imposed by the Mexican Congress. SHCP's position has been endorsed by the Fiscal Court and the circuit courts on appeal. Indeed the Circuit Court that reviewed the 1998 Fiscal Court's decision agreed that the invoice requirements in Article 4 were consistent with the application to all exports of the 0% rate under Article 2 section III (as amended since January 1992).

101. The Reply does not even mention Article 4 of the IEPS Law.

102. The Counter-Memorial's detailed account of the facts showing the authorities' complete compliance with the ruling, their advice to the District Judge that they needed the invoices with the tax separately stated, and the specifics of how they ascertained that IEPS had actually been paid on CEMSA's alcoholic beverages exports should help the Tribunal conclude that there was full compliance with the ruling.

103. It should also lead the Tribunal to reject the Claimant's characterization of the breadth of the "right" established in the 1993 Supreme Court ruling, which has also been rejected by the Mexican courts (see paragraph 16).

B. Response to the Allegation That Mexico Wrongly Refused to Pay the October-December 1997 Rebates and Thereby Violated Article 1110 of the NAFTA

104. As noted in the Introduction, the Counter-Memorial brought to the Tribunal's attention for the first time the existence of the CEMSA Fiscal Court challenge of the rebate denials and its upholding by the Circuit Court. The Claimant has now argued that the Mexican court decisions ought not to be given much weight and further that there was a denial of justice in the Circuit Court.

105. The Respondent submits that neither argument has any merit for the reasons previously stated.

C. An Estoppel Does Not Arise

106. It is respectfully submitted that the Reply overstates the scope and role of estoppel under international law. The authorities it cites belie its claim at paragraph 63 of the Reply that it "is a critical element of international law, particularly in the context of state responsibility for injury to foreign investment...". None of the cases cited by Professor Swan in his Reply Affidavit support this contention. Three of the four are border delimitation cases involving the assertion of territorial jurisdiction and acquiescence[42]. In the one state responsibility case[43], no jurisprudence arises at all because the "estoppel argument" (the word "estoppel" is not actually used[44]) was summarily rejected by the Court without any analysis at all as to its operation at international law.

107. The Respondent reaffirms its position as to the limited scope of estoppel as pleaded in the Counter-Memorial. It further submits that an estoppel cannot arise on the facts of this case. As noted in one of the Claimant's own authorities, R.Y. Jennings' Collected Writings, Vol. 2[45]:

> The first thing to be said is that the principle of estoppel in international law must be approached with some caution; for once loosed from the many technical shackles that severely limit its operation in the common law, from which it is after all by analogy derived, it is in danger of seeming to be applicable to almost any situation in which a State has expressly or tacitly adopted some attitude towards a legal question. This tends only to obscure the actual legal questions and principles involved [46].

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42. *The Temple Case, North Sea Continental Shelf Case,* and *Eastern Greenland Case.*

43. *Nottebohm.*

44. In fact, of the passages cited by Professor Swan from the four majority judgments in support of their purported authority on estoppel, the word "estoppel" is only used in one, to wit, *North Sea Continental Shelf Case* (Federal Republic of Germany v. Denmark/Netherlands).

45. R.Y. Jennings, COLLECTED WRITINGS, VOL. 2 (Kluwer Law International, 1998).

46. Ibid at page 974.

1. None of the Cited Authorities Assist the Claimant

108. The authorities cited by Professor Swan are wholly distinguishable from the instant claim, and amount to very modest and limited authority on the question of estoppel under international law.

109. It must be noted at the outset that the attempt to apply authorities dealing with States' assertions of sovereignty over disputed territory to the facts of this case requires a great over-reaching. This is due to the fact that the assertion of sovereignty at the international level is one of the most fundamental acts of legal significance in international law and any attempt by a State to assert sovereignty in disputed territory is a matter of the highest legal and political significance, bound to attract the attention of the highest levels of state of the neighbouring States involved. It is for this reason that the assertion of sovereignty, protest, recognition, and acquiescence (much more than estoppel) play a significant role in the International Court of Justice's treatment of the issue.

110. The operation of a State's taxation system in connection with an individual taxpayer simply does not equate to this area of international law and an attempt to borrow (underdeveloped and peripheral) principles from one area of international law and apply them in another should be approached with the caution that the learned commentators themselves advocate in the area where estoppel has appeared to have actually played a minor role.

111. In the interests of completeness, however, the Respondent will address the authorities cited by the Reply.

a. *The Case Concerning the Temple of Preah Vihear* (Cambodia v. Thailand)[47] (*The Temple Case*)

112. The facts of the *Temple Case* are unusual, and it is far from clear how, if at all, the estoppel principle operated independently of the principles of acquiescence and recognition[48]. As the Tribunal will know, in that case the International Court of Justice considered a land boundary delimitation where the location of an ancient temple was in dispute. Cambodia adduced a map prepared some 50 years previously by a Mixed Commission in 1907 (the "Map") which showed the Temple in Cambodian territory. Thailand did not complain of the Map's accuracy until 1958, some 50 years later. On the basis of the passage of time, and in light of the other circumstances (listed below) the Court found Siam (Thailand) to have acquiesced in Cambodia's assertion of title.

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47. *I.C.J. Reports*, 1962, p.6.

48. The word "estoppel" is not actually used in the majority opinion of the Court where it undertakes its legal analysis (at page 32). It appears only once, at the very outset some twenty pages earlier in the Court's recitation of the Parties' submissions and pleadings (at page 12)..

113. Furthermore, during that 50-year period there were several discrete acts by Siam (Thailand) that were found to amount to tacit recognition of Cambodia's (then French Indo-China's) sovereignty over the temple. These included:

a) the fact that the Map was initially accepted by the Siamese Government without protest or even comment; in fact, Siam even thanked the French authorities for it and requested additional copies;

b) in 1909, a Franco-Siamese Commission was established for the purpose of getting a Siamese geographical service started by means of consolidating the work of the Mixed Commissions of 1904 and 1907. A primary aim was to convert existing maps into atlas form in both languages. No suggestion was then made during the work of the Commission that the 1907 Map or boundary line was unacceptable.

c) in 1930, Prince Damrong of Siam made a state visit to the Temple which was flying the French flag and where he was officially received by a French official;

d) in 1934-35, Thailand conducted its own survey and took the view that the 1907 Map incorrectly delimited the watershed in a manner placing the Temple in Cambodia. Notwithstanding this, it continued for public and official purposes to use the 1907 Map and other maps showing the Temple in Cambodia;

e) in 1937, Thailand and France concluded a treaty reaffirming the frontiers, and Thailand even produced a map from its own Siamese Royal Survey Department which showed the Temple to be in Cambodia (notwithstanding the discrepancies which it claimed to have discovered in its own surveys of 1934-35); and

f) in 1947 (after Thailand had taken possession of certain parts of Cambodia in 1941 during the Second World War), a Commission was established to look into the border questions, including the frontier established in 1907. Notwithstanding the clear and obvious opportunity for Thailand to raise the Temple question on the ground of delimitation error, it did not do so, even though it raised a considerable number of complaints over other frontier lines. Thailand even produced a further map (dated 12 May 1947) showing the Temple to be in Cambodia. The inference drawn was that it accepted the delimitation of the 1907 Map *vis-à-vis* the Temple, even if believing that it had not correctly been drawn.

114. In this context of multiple acts of tacit recognition and acquiescence, the precise role of estoppel in the judgment is not clear. The majority judgment of the Court does not use the term and seems to rely upon the notion in a conditional and supplementary fashion:

> Even if there were any doubt as to Siam's acceptance of the map in 1908, and hence of the frontier indicated thereon, the Court would consider, in the light of the subsequent

course of events, that Thailand is now precluded by her conduct from asserting that she did not accept it.[49] [Emphasis added]

115. Jennings, while of the belief that estoppel or preclusion played a role, expresses his own doubt as to its centrality:

> It is evident that principles of estoppel or preclusion weighed heavily with the Court. What is not clear from the judgment is whether preclusion was regarded as one among other self-sufficient reasons for decision; or whether it was merely an adjunct of a kind of process of prescription (and certainly considerable weight was attached to the length of time during which Thailand failed to object to the map line); or whether it was regarded as being merely of assistance in a question basically one of treaty interpretation. Indeed, looking simply to the majority judgment one is hard put to it not to lump all together in an omnibus concept of "consolidation of title by lapse of time". [50] [Emphasis added; footnotes omitted]

116. With these facts in mind, the untenability of the Claimant's reliance on *The Temple Case* becomes obvious. Instead of 50 years of acquiescence, and multiple, clear acts consistent with a certain position, the Claimant is left to contend that:

- after its own litigation up to the Supreme Court,
- SHCP's subsequent insistence of the production of invoices with the IEPS stated separately (and the Claimant's production of same),
- Lynx's litigation with SHCP;
- numerous demands, petitions, and complaints by the Claimant and the rejection of same by SHCP,
- the publishing of advertisements in newspapers accusing senior officials of the Mexican Government of criminal acts for refusing to accede to his demands,
- his invocation of diplomatic assistance from the U.S. Embassy, and
- notwithstanding a system of rebates clearly established in law (referred to in the Reply as the "mechanics of the IEPS Law"),

that a limited period of payments made by a tax system that operates on the basis of trusting the taxpayer (subject to subsequent verification), and an alleged oral agreement (which is denied by SHCP, and never asserted by the Claimant in the two separate court proceedings) produces an estoppel.

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49. *I.C.J. Reports*, 1962, at p.32.

50. Jennings at pp.984-5.

b. *The Nottebohm Case* (Liechtenstein v. Guatemala)[51]

117. Professor Swan's discussion of this case seeks to convert the rejected contention of one party (Liechtenstein) into authority on estoppel under international law. Again, the word "estoppel" is not used in the judgment. Moreover, the impression left by his citation at the bottom of page seven of his affidavit is the opposite of what the case actually stands for.

118. The facts of the case, in summary form and as related to the "estoppel" argument, are as follows: Nottebohm was born in Germany in 1881 and went to Guatemala in 1905 to live and conduct business. In 1939, he returned temporarily to Germany, and on October 9, 1939, applied for Liechtenstein citizenship which he was granted later that month. He returned to Guatemala at the beginning of 1940 and later that decade he and his property were subject to a series of measures against which Liechtenstein sought redress before the Court.

119. Guatemala raised a preliminary objection against the admissibility of the claim by challenging the legitimacy of Nottebohm's Liechtenstein nationality, and, as a consequence, Liechtenstein's ability to pursue the claim on his behalf. The Court then noted that "Liechtenstein has argued that Guatemala formerly recognized the naturalization which it now challenges and cannot therefore be heard to put forward a contention which is inconsistent with its former attitude"[52]. This earlier "recogni[tion]" was contended on the basis of certain acts by Guatemala arising after Nottebohm received his Liechtenstein citizenship in October 1939.[53]

120. All of the contentions (see footnote51 for details) were rejected and Guatemala was not prevented from raising the nationality argument (on which it ultimately prevailed), notwithstanding its previous acts which were said to have precluded it from not recognizing Nottebohm as a Liechtenstein national.

121. The Respondent takes no issue with Professor Swan's account of the case in paragraph 12, and the first half of paragraph 13 of his Affidavit. However, the manner in which he then cites the Court's judgment following his last four lines of paragraph 13 is misleading. They bear repeating:

> 13. ....They [the statements and other actions of Guatemalan officials] were being used to estop Guatemala from denying Liechtenstein's *legal right* to extend diplomatic protection to Nottebohm before the ICJ. This is expressly confirmed by the Court when, after reviewing all the evidence relied upon by Liechtenstein, it concluded:

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51. *I.C.J. Reports*, 1955, p.4.

52. At p.17.

53. These included the fact that: (1) Nottebohm was granted a visa by the Guatemalan Consul General in Zurich on December 1, 1939 for his return to Guatemala; (2) at the request of Nottebohm, Guatemala amended his entry in the Register of Aliens to reflect his new Liechtenstein nationality; (3) a similar amendment was made to his identity document; (4) a certificate to the same effect was later issued by the Civil Registry; and (5) after Nottebohm raised the claim, the Minister of External Affairs for Guatemala indicated in a communication to the Court that its Government was willing to negotiate with the Principality of Liechtenstein "with a view to arriving at an amicable solution". (pp. 17-19)

"There is nothing[54] to show that before the institution of proceedings Guatemala had recognized Liechtenstein's title to exercise protection in favor (sic) of Nottebohm and that it is thus precluded from denying such a title." [Underlined emphasis added; *italics* are original]

122. Professor Swan leaves the impression that the Court agreed with Liechtenstein in the sense that the Court ruled that Guatemala "was precluded (*i.e.*, estopped) from denying such a title [its right to exercise diplomatic protection]". This is incorrect. In context, it is clear that the concluding words of the above quotation ("it is thus precluded from denying such a title") are modified by the introductory language and they actually mean that there was nothing that precluded Guatemala from contesting Liechtenstein's exercise of diplomatic protection, which it of course it did. Ultimately, the International Court of Justice agreed and the claim was dismissed for want of standing.

123. The case is thus of no assistance to the Claimant.

c. *North Sea Continental Shelf Case* (Federal Republic of Germany v. Denmark/Netherlands)[55]

124. As with *Nottebohm,* the *North Sea Continental Shelf Case* is not an authority *per se* on estoppel, as the Court mentioned the issue only in the course of summarily rejecting an argument due to the complete lack of evidence in support thereof. No analysis is undertaken at all on the principle of estoppel. The Court simply raised it to dispose of an argument that was merely a theoretical possibility ("It appears to the Court that only the existence of a situation of estoppel could suffice to lend substance to this contention") and that it did not have to consider that given the lack of evidence.

125. It can not even be characterized as a considered form of *obiter* such as when a court rules that if a party were to have proved a certain fact (in the *North Sea Continental Shelf Case,* the fact that the Federal Republic had by conduct evinced acceptance), it would apply a certain legal concept (*i.e.*, estoppel) leading to a certain result. Absent this or any other indication that the Court had truly considered the operation of estoppel and approved of its application, the judgment is of no assistance to the Claimant.

d. *Legal Status of Eastern Greenland* (Norway v. Denmark)[56]

126. This case requires even less comment. The judgment has nothing to do with estoppel. The case rests on a straight-forward interpretation of a variety of international instruments which clearly established Norway's recognition of Danish sovereignty. The Claimant's citation of the passage that states that given Norway's execution of various agreements "Norway reaffirmed

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54. The cite is misquoted as the word "here" is missing in between the words "nothing ... to show".

55. *I.C.J. Reports*, 1967, p.3.

56. *P.C.I.J. Reports*, Series A, No. 53, p. 22.

that she recognized the whole of Greenland as Danish; and thereby she has debarred herself from contesting Danish sovereignty" clearly speaks of multiple acts of "recogni[tion]", not estoppel. The words "she has debarred herself" is simply a turn of phrase reflecting that the Court would not permit Norway to renounce its previous positions and commitments as reflected in the agreements it had signed.

127. The cases cited by the Claimant all[57] involve the judicial evaluation of States' long-standing positions on matters over which they must be presumed to have considered with the greatest degree of seriousness: namely, the boundaries of the State and its territorial integrity. These cases and the legal effects attached to the conduct of States in such circumstances are simply not comparable to the manner in which a very large bureaucracy of a State deals with a single taxpayer amongst many others.

2. Estoppel Under Municipal Law

128. In Mexico's submission, contrary to the contention at paragraph 62 of the Reply, the general approach taken by the domestic courts of the three NAFTA Parties regarding estoppel in relation to taxation matters is relevant to this Tribunal.

129. Although the Reply objects to the consideration of the domestic law of the three NAFTA Parties[58], the Respondent observes that the Claimant readily cited municipal legal authorities in the Memorial when it suited his purpose[59].

130. Moreover, estoppel at international law is derived from municipal law. The article by Jennings, cited by the Claimant, and quoted above at paragraph 107 makes this point (and, indeed, a related point made in the Counter-Memorial)[60].

131. The Claimant does not contest the Respondent's proof that under the domestic law of each of the three NAFTA countries, taxpayers have no legal entitlement to rely on oral advice of tax officials and that there cannot be an estoppel created as to the interpretation and operation of legislation, as that falls within the jurisdiction of the courts[61].

132. It is also observed that the Claimant does not dispute that he did not even attempt to argue in his 1998 and 1999 court challenges that SHCP was estopped by any alleged oral agreement with the Claimant.

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57. With the exception of course of *Nottebohm* which simply rejected any notion of estoppel in that case, and never discussed the concept generally.

58. Reply at paragraph 62.

59. See footnotes 46, 89, 92, and 100 of the Memorial.

60. At paragraph 405, where Professor Brownlie makes this point that estoppel in municipal law is regarded with "great caution".

61. Professor Swan's argumentation regarding the content of the U.S. domestic law governing "estoppel" of tax authorities is further evidence that he is acting in this case not as an expert witness, but rather as an additional legal advocate, because Professor Swan has no apparent experience or expertise of any kind with U.S. tax law.

133. The Claimant did argue to the Mexican Fiscal Tribunal that SHCP's granting of rebates in 1996 and 1997 constituted tacit resolutions favorable to CEMSA, which were revoked in violation of Article of the 36 of the Fiscal Code (the Tribunal should note that in making its submissions CEMSA implicitly argued that such individual "tacit favorable administrative resolutions" were Article 34 resolutions establishing rights for the taxpayers and which can only be modified or revoked by the Fiscal Court pursuant to Article 36 of the Fiscal Code[62]), and thus, SHCP's conduct estopped it from denying rebates in late 1997. The Fiscal Tribunal rejected this argument, stating that there was no evidence that SHCP had issued any favorable resolution, but rather, the only resolution of SHCP (*i.e.*, the 24 February 1998 resolution in response to the 12 December 1997 inquiry) was unfavorable. The Fiscal Tribunal's ruling on this issue was left undisturbed by the Circuit Court on appeal.

134. Regarding U.S. domestic practice on whether tax authorities can be estopped, Professor Swan cites a single 1963 decision of the U.S. district court for the Eastern District of Tennessee, in which the court applied a particular provision of the U.S. Tax Code. Even Professor Swan concedes:

> Admittedly, the [case on which he relies] may be a narrow exception because it dealt with Section 482.

135. From this one case, Professor Swan derives a convoluted and novel theory that estoppel may be available where governmental tax authorities have a certain degree of discretion in applying the pertinent statute. He argues on this basis that the U.S. law is "complicated."

136. As discussed in the Counter-Memorial, however, U.S. law as reflected in the current regulations, and in holdings of the U.S. Supreme Court, is clear –both on the issue of oral advice and on estoppel more generally.

137. The Counter-Memorial also quoted from a recent decision of the Tax Court of Canada holding to similar effect – specifically, that "estoppels cannot override the law".

138. More fundamentally, the Claimant and Professor Swan misapprehend the Respondent's purpose in describing the domestic law of the three NAFTA Parties on the issue of estoppel of tax authorities. The law of Mexico, the United States and Canada is of relevance for the following reasons.

139. First, in both Claimant's country of citizenship (the United States) and his country of permanent residence (Mexico) the conduct alleged by the Claimant could not have estopped the tax authorities from enforcing the law. This helps to demonstrate that the Claimant could not reasonably have believed that he actually had a legal right to obtain IEPS rebates without having the required invoices expressly stating and transferring the tax. The content of the domestic law therefore is pertinent to disproving the Claimant's allegation that there was actual reliance.

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62. [R 06328-29] [pages 22-23]. The operation of Articles 34 and 36 of the Fiscal Code are explained in Eduardo Díaz Guzmán's Second Witness Statement at paragraph 6 (CM 6009), Fernando Heftye's Witness Statement at paragraphs 8-10 and 16 (CM 06025-06027) and in the Counter-Memorial at paragraphs 148, 172-176, 234-235 and 411-414.

140. Second, the domestic law is useful in evaluating the Claimant's assertion that there is an international law of estoppel that is directly applicable to SHCP. In this regard, there is no provision of NAFTA Chapter Eleven that purports to create an obligation on domestic tax authorities to exempt investors of the other NAFTA Parties from the normal responsibilities of taxpayers to ascertain the law through the established domestic mechanisms. To the extent the Claimant is arguing that such a duty is imposed through Article 1105, the Respondent disagrees substantively, but in any event has already shown that Article 1105 does not apply to taxation measures.

141. Just as importantly, however, it would be extraordinary to conclude that the three NAFTA governments would impose an obligation on their own tax authorities through the NAFTA that was directly contrary to their existing domestic laws.

142. To the extent that the Claimant may be arguing that its interpretation of estoppel somehow should be applied as "customary international law," the domestic law of the NAFTA Parties is also relevant. As explained by Jennings and Watts:

> ... the substance of this source of international law [customary international law] is to be found in the practice of states. The practice of states in this context embraces not only their external conduct with each other, but is also evidenced by such internal matters as their domestic legislation, judicial decisions, diplomatic dispatches, internal government memoranda, and ministerial statements in Parliaments and elsewhere. [63]

143. They go on to state that "...uniform municipal legislation constitutes in a sense evidence of international custom ..."[64] Because the three NAFTA Parties take the same approach under their domestic laws to estoppel of tax authorities –an approach opposite to that for which the Claimant contends– the Claimant has failed to show that there is a principle of customary international law that would bind SHCP to purported oral interpretations, or that even would preclude SHCP from changing its interpretation of the tax law.

V. ADDITIONAL FACTS RELATING TO THE NATIONAL TREATMENT CLAIM AND TO PUBLIC POLICY

A. The Central American Sales

144. The Claimant contends in the Reply:

> All of its sales were real, *i.e., bona fide* exports to real customers, unrelated to CEMSA. There is no shred of evidence to the contrary, and no Mexican authority has charged that CEMSA failed to make any of the exports for which it claimed IEPS rebates.

145. In fact, this is incorrect.

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63. Jennings and Watts, Oppenheim's International Law (9th Ed. 1996) at p. 26.

64. Ibid. at p. 26, fn. 6.

146. As pointed out in the Counter-Memorial (at paragraph 87), under the IEPS Law in force since 1992, only exports to countries that were not considered low income tax jurisdictions (tax havens) were eligible for a 0% rate. In 1997, the Foreign Trade Miscellaneous Regulations (*Resolución Miscelánea de Comercio Exterior para 1997*) extended the application of the 0% rate to final exports destined to countries considered as low income tax jurisdictions, provided that the goods were imported for final consumption in such countries, and that the exporter notified SHCP that their sales were to non-related parties (at paragraphs 95 and 220)[65]. The Claimant acknowledges this at paragraph 71 of the Reply.

147. Exporters are required to identify in their export pediments and invoices the country of destination and the name of the importer. The law does not simply request an indication of "foreign customers" and destinations at "points prescribed by them".

148. The Claimant identified Honduras and El Salvador as the countries of destination and Dilosa and INPEXSA as the importers, and submitted the notice required by the Foreign Trade Regulations indicating that CEMSA and such companies were non-related parties.

149. SHCP subsequently verified this information directly with the governments of Honduras and El Salvador. Both confirmed that neither importer existed in their respective countries (in fact, they were not registered as taxpayers, importers or in the commerce registries, respectively, and the telephone numbers and addresses contained in the letters of the purported legal representatives, which were supplied by CEMSA along with its notice, did not exist in the respective countries), and that no imports from CEMSA had entered Honduras and El Salvador. The evidence is contained in the following documents:

- Article 2 section III of the IEPS Law in force in 1997 (CM 03761 and CM 03780);
- Rule 6.1.1 of the Foreign Trade Miscellaneous Regulations (CM 03782);
- the notice filed by the Claimant on behalf of CEMSA on 6 November 1997 with SHCP's General Direction of International Tax Matters pursuant to Rule 6.1.1, including two letters purportedly issued by the legal representatives of INPEXSA (Rául Gutiérrez Maradiaga) and Dilosa (Nelson Rigoberto López) (App. 0369-0374 to the Memorial);
- the letters of 15 March 1998 from SHCP's General Direction of International Tax Matters to the Executive Director for Revenue of Honduras and the General Director of Customs of El Salvador, respectively (CM 04721-04727);
- the 3 April 1998 letter from the Executive Director for Revenue of Honduras to SHCP (CM 04768-04769).
- the 29 June 1998 letter from the Ministry of the Treasury of El Salvador to SHCP (CM 04800-04801);

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65. CM 03782.

- the Claimant's submission of 18 September 1998 to SHCP responding to the findings of the audit, where, in respect of Dilosa and INPEXSA, it reiterated that they were not related to CEMSA and attached "proof of the existence of such enterprises", consisting of a new declaration of Raúl Gutiérrez Maradiaga stating that he is the legal representative of Dilosa, INPEXSA and other companies, and that they are not related to CEMSA (CM 04948-04951 and 04967)[66];

- a copy of the deed of incorporation of "Distribuidora López Santamaría, S.A. de C.V." or "simply Dilosa", provided to SHCP, which states that DILOSA was incorporated and domiciled in Nicaragua, not in Honduras (CM 04473);

- the 27 October 1998 letter from the Executive Director for Revenue of Honduras to SHCP specifying the requirements to be met by any company in order to engage in trade in Honduras, including registration as a taxpayer (CM 05775-05782), which Dilosa did not have; and

- the Claimant's arguments before the Fiscal Court in the 1999 proceedings where he denied having exported to Honduras and admitted that Dilosa did not exist (Counter-Memorial at paragraph 258 and CM 05089-90).

150. The domestic courts upheld SHCP's finding in the audit that CEMSA's purported sales to Dilosa were invalid. The Reply does not contest this fact or otherwise seek to explain CEMSA's conduct other than to state in response to the Counter-Memorial's paragraph 258, which quoted CEMSA's argument before the court denying that the Dilosa transactions to Honduras had ever occurred,

> Admitted that this is an excerpt of a statement made by CEMSA's then attorney Javier Moreno Padilla[67].

151. The Tribunal should note that at paragraph 69 of the Reply the Claimant has agreed "that no rebates would be due for fictitious sales".

B. The U.S. Shipments

152. The Claimant's Admissions and Denials deny the detailed invoice-based transactions reviewed in the Counter-Memorial[68]. Given that most of the documents in question emanated from CEMSA, this denial is implausible.

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66. The declaration was submitted twice. The first one refers to "INVEXA, S.A." and "Corporación de Exportación, S.A. de C.V. – CENSA"; and was substituted for another one that refers to "INPEXA, S.A." and "Corporación de Exportaciones Mexicanas, S.A. de C.V. and/or Marvin Feldman". Although the date of certification by the Notary Public is the same in both, the certification by the Supreme Court of Justice of Nicaragua is 7 September 1998 in the first case and 17 September 1998 in the second one.

67. Admission to the Counter-Memorial's paragraph 258. The Respondent wishes to highlight, however, that the submissions before the Circuit Court, as were all others, were made by "Marvin Roy Feldman Karpa, legal representative of the abovementioned corporation", *i.e.* CEMSA (CM 05074).

153. In reply to paragraph 464 of the Counter-Memorial, the Claimant says that he "has no knowledge on which to admit or deny this or the following paragraphs 466-467, 469-472". By this, he asserts that he is unable to admit or deny the ownership and officers/directors of Lynx, Mercados Regionales (Mercados I, formerly Compañía Exportadora Mexicana) and Mercados Extranjeros (Mercados II).

154. Yet he and his lawyer, Mr. Enríquez, in various statements have exhibited a more than passing knowledge of the affairs of Lynx, Compañía Exportadora/Mercados Regionales, and Mercado Extranjeros. Of course, Mr. Enríquez acted for both CEMSA and Lynx in relation to their IEPS litigation against SHCP.

155. Even though CEMSA's invoices, export pediments and freight documents routinely referred to Eduardo Silva and J & E International Sales, Inc. of El Paso, there is no discussion in the Reply of the fact that all of CEMSA's 1997 shipments to the United States ended up in El Paso.

156. The Claimant does not attempt to explain how his shipments to Lynx, Compañía, GTO Produce, GTO International Trade, and International Commerce Co. all ended up with Mr. Silva.

157. As noted earlier, it is now established that the cigarettes were then shipped back to Mexico by J & E International Sales.

158. The Claimant continues to claim that he had no business relationships with Messrs. Poblanno, Gámez, or Güemes other than earlier testified, but says nothing in the face of a large volume of documents from his own files and other files linking Lynx, Compañía, and GTO to CEMSA.

159. The Claimant's attitude towards selling to fictitious companies is particularly striking, especially in light of the fact that cigarettes are a highly-regulated product subject to extensive taxes and labeling requirements and that it has now been proven that his exports found their way back to Mexico (and hence were not traded on "world markets as the Reply puts it). At paragraph 23 of the Reply, the Claimant states:

> Respondent's assertions that Mexican cigarettes could not be imported into the United States and that CEMSA's customers were "fictitious" companies are immaterial. CEMSA's exports and its customers were real whatever names the customers used for business purposes. Brand-name products, including cigarettes, may be legally exported from Mexico and traded in world markets without the consent of the trademark holders. Such sales commonly are effected through intermediaries who may choose, for valid business reasons, not to disclose their customers or even their proper corporate names. (See Feldman Decl. ¶ 74.)[69]

Footnote continued from previous page

68. See paragraphs 460-462, for example.

69. At paragraph 70 of the Reply, the Claimant asserts: "The question of whether and where CEMSA's customers were incorporated and under what names they did business is wholly irrelevant. An individual, or a company, generally may do business under any name or legal form that it chooses." To the contrary, when an

Footnote continued on next page

160. The paragraph of the Claimant's earlier declaration that is cited asserts that it is common for purchasers not to disclose their customers to a seller such as the Claimant "for fear of being cut out of the middle of the transaction." Even if true, this assertion provides no justification for a purchaser to give a false country of destination or a false name for itself, or the vendor to concur with such attempts. Regardless of any "business reasons", the information legally required for tax and customs purposes must be truthful without exception.

161. However, even the Claimant says that if he had known that the cigarettes were being shipped back to Mexico, he would not have engaged in the trade. In his Reply witness statement he testifies that:

> 5. All of CEMSA's cigarette exports were for definitive export from Mexico. I have no knowledge that any cigarettes exported by CEMSA were ever returned to Mexico. None of CEMSA's customers ever said anything to me suggesting (1) that cigarettes purchased from CEMSA would, or had been, returned to Mexico or (2) that they or any enterprise in which they were involved was engaged in smuggling cigarettes into Mexico. I would have halted sales immediately if I had any such suspicion.

162. The Claimant thus acknowledges that the "round-trip" shipment of cigarettes from Mexico City to Houston or Dallas, then on to El Paso and back to Mexico is not a legitimate business. It raises domestic law questions as to whether definitive exports of cigarettes were made such as to entitle CEMSA to even apply for IEPS rebates (quite apart from its lack of invoices). It also raises domestic law questions as to contravention of Mexico customs law (as the evidence of Mr. Rolando García is that Mexican import statistics record no imports through Ciudad Juárez for 1996-1997, yet the new evidence shows that Eduardo Silva shipped cigarettes from El Paso to Ciudad Juárez).

163. In addition to being relevant to the evaluation of the national treatment and public policy issues, this evidence and the Claimant's own admissions are relevant to his damages claim. No *bona fide* purchaser, fully informed as to the true nature of this cigarette exporting business, would accord any value to the business. To the contrary, it is a liability when the fiscal authorities become aware of the true dimensions of the scheme.

C. There Was No Denial of National Treatment

1. The Incorrect Factual Predicate of the National Treatment Claim: CEMSA's So-Called "Competitors"

164. The Reply objects to the suggestion that CEMSA was intimately involved with Mexican-owned companies that it portrayed as its competitors[70].

Footnote continued from previous page
individual or company does business under a false name, or gives a false address, it can be an indication that such person or company is engaged in illegal behavior.

70. See paragraph 20 forward.

165. This denial is implausible given the Claimant's own testimony about his relationship with Mr. Poblanno and his colleagues, the fact that his lawyer was their lawyer and handled the different companies' legal affairs, and the substantial documentary evidence demonstrating that those companies or the persons directing them were simultaneously CEMSA's financiers, suppliers, and customers.

2. Features of the IEPS Law That Bear Upon the Issue of "Like Circumstances"

166. The Reply mocks the Counter-Memorial's description of the way in which the IEPS Law operates[71]. The Respondent reiterates that the system is based on the assumption that the taxpayer is trustworthy, subject to subsequent verification and assessment if necessary. There is nothing unusual about this type of statutory scheme. The tax systems of the three NAFTA Parties all operate on the same principle.

167. There is no doubt that each scheme is susceptible to tax evasion and manipulation and that the authorities in all three NAFTA Parties do not succeed in detecting all instances of evasion. There is also no doubt that when they do detect defects in tax returns, the authorities will take action against recalcitrant taxpayers.

168. This must be kept in mind when considering the treatment of enterprises in "like circumstances".

3. Response to the Reply's Main Argument on National Treatment and Like Circumstances

a. The Gravamen of the Violation is Discrimination Based Upon Nationality

169. A national treatment violation depends upon less favorable treatment being accorded to the investment of an investor due to his nationality. In two rounds of pleadings filed to date, the Claimant has not adduced any evidence of discriminatory treatment based on his nationality.

170. At paragraph 7 of the Reply, the Claimant notes that the Respondent pointed out that the Tribunal cannot examine a government's motives. That is correct. With respect, however, the Claimant has failed to distinguish between motivation and discriminatory treatment under the national treatment test. Less favorable treatment based upon nationality (or in the case of goods, the origin of the goods) is the central question when examining whether a State has complied with its national treatment obligations. This is the object of analysis of GATT Article III and is the object of a NAFTA Article 1102 analysis.

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71. At paragraph 14 forward.

171. But discriminatory treatment based upon nationality of capital or origin of goods is not to be confused with the motivation behind the discriminatory treatment. The point is illustrated in the *Cross-border Trucking Services Case* to which the Respondent referred in its Counter-Memorial. There the measures at issue clearly accorded less favorable treatment to Mexican service providers, on the one hand, when compared to U.S. and Canadian services providers, on the other, on the basis of nationality. The motivation for the discriminatory treatment (whether the U.S. President decided not to implement the United States' NAFTA transportation obligations in order to placate a union) was the factor that the Panel declined to consider. However, the whole case turned on the less favorable treatment accorded to Mexican services-providers and the Panel examined the discriminatory treatment based on nationality.

172. It is respectfully submitted that the *Pope & Talbot* Award, cited at paragraph 8 of the Reply, improperly defined the national treatment rule. At paragraph 78-79 of the award, that Tribunal set out its version of the analysis under Article 1102, stating:

> 78. In evaluating the implications of the legal context, the Tribunal believes that, as a first step, the treatment accorded a foreign owned investment protected by Article 1102(2) should be compared with that accorded domestic investments in the same business or economic sector. However, that first step is not the last one. Differences in treatment will presumptively violate Article 1102(2), unless they have a reasonable nexus to rational government policies that (1) do not distinguish, on the face or *de facto*, between foreign-owned and domestic companies, and (2) do not otherwise unduly undermine the investment liberalizing objectives of NAFTA.
>
> 79. In one respect, this approach echoes the suggestion by Canada that Article 1102 prohibits treatment that discriminates on the basis of the foreign investment's nationality. The other NAFTA Parties have taken the same position. However, the Tribunal believes that the approach proposed by the NAFTA Parties would tend to excuse discrimination that is not facially directed at foreign owned investments. A formulation focusing on the like circumstances question, on the other hand, will require addressing *any* difference in treatment, demanding that it be justified by showing that it bears a reasonable relationship to rational policies not motivated by preference of domestic over foreign owned investments. That is, once a difference in treatment between a domestic and a foreign-owned investment is discerned, the question becomes, are they in like circumstances? It is in answering that question that the issue of discrimination may arise. [72] [Emphasis added]

173. The Tribunal seemed to reject the common view of the three NAFTA Parties that the gravamen of an Article 1102 violation was discriminatory treatment based upon nationality

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72. In the underlined passage quoted above, the *Pope & Talbot* Tribunal erred in using the like circumstances test to focus on "*any* difference in treatment". The reason this goes too far is that it assumes that there will not be differences in treatment within the class of domestic goods or investors, or differences in treatment within the class of imported goods or foreign investments, or differences in treatment within all goods (irrespective of origin) or all investments (irrespective of nationality of capital) for reasons other than the origin of goods or the nationality of capital. Such differences are permitted without running afoul of the national treatment rule; however, the *Pope & Talbot* award's formulation of the test could reach such legitimate differences in treatment. This was recognized by the *Cross-border Trucking Services* Panel Report, where in its recommendations, it observed that legitimate differences in treatment may occur in respect of different classes of investments. See paragraphs 300-301.

(whether or not that discriminatory treatment is *de jure* or *de facto*). If that is what the Tribunal intended, it is respectfully submitted that the Tribunal was in error.

174. Obviously, since each NAFTA Party is a capital exporter as well as a capital importer, when formulating their legal positions on the meaning of this key provision of Chapter Eleven, they had to balance their own interests. Their shared view that nationality had to be the basis for the according of less favorable treatment was based on settled GATT/WTO practice in the 'trade in goods' context and upon sound policy. The Tribunal should have attributed much more weight to their shared view before departing from it.

175. Even so, in its actual application of its test, the *Pope & Talbot* Tribunal followed an approach closer to that agreed by the NAFTA Parties, because it still looked at whether Canada had discriminated based upon nationality. At paragraph 93 of the award, for example, the Tribunal stated:

> For these reasons, the Tribunal concludes that the new entrants' allocation choice by Canada had a reasonable nexus with the rational policy of providing for new entrants and it had no elements of discrimination against foreign-owned producers. [Emphasis added]

176. At paragraph 97 the Tribunal concluded:

> ...the Tribunal firstly concludes that, at least until the advent of the stumpage reductions discussed below, the Investment received treatment no less favorable that that accorded Canadian-owned producers throughout B.C. [Emphasis added]

177. At paragraph 103 the Tribunal concluded

> ...there is no convincing evidence that it [a settlement between Canada and the United States] was based on any distinction between foreign-owned and Canadian owned companies. [Emphasis added]

178. Finally, at footnote 86 the Tribunal stated:

> ...there is no hint that the decision to place the burden on the many users of [particular types of quota] was motivated by the nationality of one of those users, the Investment. [Emphasis added]

179. In the result, therefore, that Tribunal focused on discrimination based upon nationality.

180. Moreover, in the GATT/WTO context, by definition, the national treatment rule distinguishes between goods based upon their origin, *i.e.*, domestic versus foreign. The rule can only come into play once imported goods have crossed the customs border and entered into the internal commerce of a WTO Member. A reading of GATT Article III shows the drafters' concern that, having cleared all customs formalities and applicable duties having been levied, imported goods may not then be the object of further discrimination. In every case, the focus of the national treatment analysis has been upon discrimination between goods due to their origin.

181. No assistance is afforded to the Claimant by the WTO panel report in *United States -- Standards for Reformulated Gasoline*. That case involved a U.S. regulation that discriminated

against imported gasoline *de jure*[73]. The decision turned on whether such differential treatment could be justified under the general exceptions to the GATT contained in Article XX[74].

182. The passage cited by the Claimant comes from a discussion of a subsidiary argument, made by the United States, that differential treatment could be justified because of different characteristics of the refiners, blenders and importers who distributed the gasoline, and the nature of the data held by them. The panel held that, consistent with prior GATT practice, an evaluation of the comparative treatment of foreign and domestic gasoline had to focus on the characteristics of the gasoline itself[75]. This is an unremarkable holding that offers no support to the Claimant's argument.

183. As noted above, there has been no attempt by this Claimant to prove that due to the Claimant's nationality, CEMSA was treated less favorably than Mexican-owned enterprises in like circumstances.

184. In fact, all taxpayers that have unduly obtained IEPS rebates, including CEMSA, have received the same treatment, as explained by Lic. Eduardo Díaz Guzmán in his First and Second Statements. All have been investigated and assessed, except for two taxpayers where the assessment is pending.

185. This also shows that the mechanics of the IEPS tax/rebate system has operated in the same manner in every case. The Claimant admits that the system operates in the manner described by the Respondent in the case of the value added tax (IVA). As explained by Lic. Eduardo Díaz Guzmán in his First and Second Witness Statements, the system is identical for all taxes, including IEPS and IVA. The application required to be submitted and the processing of the application, including the procedure by which it is rejected or approved and payment made is the same (although certain documentary requirements may vary in some cases).

b. The Claimant's Attempt to Exploit the Domestic Law Prohibition on Disclosure of Confidential Taxpayer Information

186. The national treatment allegation presents special problems of proof for the defense because SHCP is bound by domestic law to preserve taxpayer confidentiality. The Respondent

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73. Under the regulation at issue, gasoline distributed by importers was subject to different requirements than gasoline distributed by domestic refiners.

74. See *United States --Standards for Reformulated Gasoline*, WT/DS2/R (29 Jan. 1996) at paragraph 8.1 ("The Panel concluded that the baseline establishment methods ... are not consistent with Article III:4 of the General Agreement, and cannot be justified under paragraphs (b), (d) and (g) of Article XX of the General Agreement.") The United States appealed to the Appellate Body only the holdings of the panel dealing with Article XX. Report of Appellate Body, WT/DS2/AB/R (29 April 1996), Section II.A.

75. Panel Report at paragraph 6.11 ("... Article III:4 of the General Agreement deals with the treatment to be accorded to like products; its wording does not allow less favourable treatment depending on the characteristics of the producer and the nature of the data held by it.")

cannot disclose names and provide details of what actions it has taken or is in the course of taking against other taxpayers for impermissible claims of IEPS rebates.

187. The Reply seeks to exploit this domestic law restraint on the defense by criticizing the Respondent for complying with its taxpayer confidentiality law and failing to discharge the burden of proof (see paragraph 1 of the Reply).

188. The Respondent objects to this tactic, but, for the reasons noted below, it is unnecessary in this case to consider this issue further.

c. In Any Event, The Claimant has Adduced Evidence of Action Being Taken Against Mexican-owned Enterprises Who Also Collected IEPS Rebates

189. In a statement filed with the Counter-Memorial, Lic. Eduardo Díaz Guzmán sets out what can be disclosed at law in terms of actions taken by SHCP in relation to other cigarette re-sellers who have improperly claimed IEPS rebates. Lic. Díaz Guzmán's testimony indicates that there were payments made and assessments have been made in the case of two companies and investigations initiated in three other cases.

190. There is independent evidence that action has been taken by SHCP against Mr. César Poblanno, a principal in Lynx, Compañía Exportadora Mexicana/ Mercados Regionales and Mercados Extranjeros. This evidence was provided to the Tribunal by the Claimant.

191. In a letter to the Tribunal dated 18 January 2001, counsel for the Claimant complained about a *subpoena* being issued to the Claimant requesting "information concerning CEMSA's relations with Mr. César Poblanno González, a principal in Mercados Extranjeros, S.A. de C.V. ("Mercados") and a former lender to CEMSA" which *subpoena* was "made in support of a personal audit of Mr. Poblanno said to date from August 11, 2000".

192. Counsel's letter enclosed a copy of the *subpoena* dated 12 January 2001, which itself referred to an *oficio* dated 11 August 2000 in relation to the audit of Mr. Poblanno for the period 1 January-31 December 1997. This evidence could not be supplied by the Respondent under the applicable law. However, since it is before the Tribunal, the Respondent notes that it is independent evidence corroborating and elaborating upon Lic. Díaz Guzmán's testimony.

193. In addition to Mr. Oliver's testimony and the *subpoena* issued in connection with an audit of Mr. Poblanno, there is ample evidence of the Claimant's own making and documents that are before the Tribunal showing that other cigarette re-sellers of Mexican ownership in like circumstances to CEMSA have been or are being dealt with by the authorities. For example:

- There is extensive record evidence of SHCP's opposition to Lynx Exportadora's attempts to claim IEPS rebates. This led to two separate judicial proceedings (after which Lynx became CEMSA's customer in the United States)[76];
- Mr. Enríquez testifies in his second statement filed with the Reply that after the completion of litigation with SHCP, "at the end of December 1996 or the beginning of 1997, the stockholder of the [Lynx] company [a reference to Mr. Poblanno] decided to close the company and formed a new company called "Cemex Compañía Exportadora Mexicana, S.A. de C.V."[77];
- After Lynx stopped importing cigarettes from CEMSA into the United States, Mr. Poblanno's new company to which Mr. Enríquez referred, Compañía Exportadora Mexicana, became CEMSA's "U.S." customer;
- CEMSA then began to ship cigarettes to the GTO companies, which as the documents filed with the Counter-Memorial showed, were also affiliated with Compañía[78];
- Compañía then became Mercados Regionales (Mercados I). The Claimant testified in his second declaration dated 17 August 2000 that "[a]pparently, our complaints before this Tribunal about this discrimination complicated Mercados' arrangements with Hacienda, and its owners made efforts to substitute a new corporation as the exporter of record, Mercados Extranjeros S.A. de C.V. ("Mercados II")"[79];
- In his third statement dated 28 March 2001, the Claimant testified further that the owners of Mercados I "tried to substitute a new corporation as the exporter...("Mercados II")... I learned this from Mr. Poblanno, who complained to me about this treatment"[80].

194. Thus, there is ample record evidence that Mexican-owned enterprises in like circumstances to CEMSA are being investigated. Some were the Claimant's financiers, suppliers, and customers.

d. The Claimant's Formulation of the Article 1102 Test Stops Short

195. It is asserted at paragraph 12 of the Reply that:

> If Mercados I, Mercados II, and other unnamed companies owned by Mexican nationals are re-sellers exporting cigarettes, and if they are receiving IEPS tax rebates denied to

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76. Table 2 of Rolando García's witness statement summarizes all of the available invoice data of CEMSA's transactions in 1996-1997. It shows that Lynx shifted from directly exporting cigarettes with IEPS rebates to being CEMSA's prime customer in the United States from July 1996 to January 1997.

77. See statement of Oscar Roberto Enríquez Enríquez at paragraph 8bis.

78. See Counter-Memorial at paragraphs 479-481.

79. Feldman second statement at paragraph 29.

80. Feldman third statement at paragraph 92.

CEMSA, there is a NAFTA violation under the ordinary meaning of the words used in Article 1102

196. With respect, this proposition is incomplete. It ignores the fact that the system is based on the assumption of a trustworthy taxpayer, subject to verification at any time up to five years later. Thus, under the system as structured, other taxpayers have obtained IEPS rebates that they were not be entitled to, and were subsequently investigated.

197. As explained in the Counter-Memorial and above, of the five taxpayers that have engaged in similar acts to those of CEMSA's, two were denied rebates and the other three have been investigated; one of the latter has been assessed, and the assessments in the other two cases is pending. In all cases SHCP will claim the money back. Other taxpayers are not receiving more favorable treatment.

e. The Sectoral Exporters Registry: CEMSA is not in "like circumstances"

198. As noted above, CEMSA was denied registration in the Sectoral Exporter's registry because it has outstanding fiscal obligations. Tax regulations require registration to be suspended in such cases.

199. CEMSA is, therefore, not in like circumstances to other taxpayers that have been registered. Where other taxpayers, such as Mercados Extranjeros have incurred irregularities or had outstanding fiscal obligations, registration has been equally denied.

200. In CEMSA's specific case, as testified by C.P. Gabriel Oliver and shown in Lic. Obregón's memorandum of 1 September 1999 to Simón Vargas Aguilar, it was recommended that CEMSA not be registered "until such time as it has complied with all its fiscal obligations". To date, it has not.

201. Thus, there has been no denial of national treatment vis à vis other taxpayers that have been registered in the Sectoral Exporter's Registry.

VI. DEFENSE TO THE CLAIM FOR DAMAGES

202. The Tribunal has received unrebutted evidence of CEMSA's shipments of cigarettes to two companies in Central America that turned out to be fictitious (Dilosa and INPEXSA).

203. It has now received evidence that the cigarettes that were ostensibly exported to the United States went to FTZ 68 in El Paso, Texas and then went back to Mexico.

204. This evidence shows that the "cigarette exporting business" was not a legitimate business. Even Mr. Feldman agrees that smuggling is a serious problem[81] and he says that he would have halted sales immediately if he had any suspicion that this was occurring[82].

205. No *bona fide* purchaser properly instructed as to the true nature of this business would be willing to pay any sum of money for it. Moreover, the potential liability for re-assessment of taxes claimed for allegedly definitive exports of cigarettes would lead a *bona fide* purchaser to conclude that it would be foolhardy to purchase such a business.

206. The Claimant's reply to the Respondent's defense to the claim for damages is limited to an attempt to show that CEMSA could have charged a higher price for the cigarettes it exported if Mr. Feldman had known that he was over-estimating the amount of IEPS paid by cigarette producers on the goods CEMSA purchased from Sam's Club.

207. The Claimant's expert on damages now contends that the CEMSA could have achieved a gross profit margin of 34.8%, after obtaining an IEPS rebate in the proper amount, simply by raising its average price from 4.09 U.S. dollars per carton to 6.14 U.S. dollars per carton, an increase of 50%[83].

208. The Respondent will demonstrate that this opinion —in addition to being contrary to settled economic theory and the Claimant's prior testimony— is contradicted by Economia's export data and the Claimant's actual pricing behavior which show that CEMSA was charging the highest price the market would bear.

209. The Respondent will also demonstrate—through the supplementary opinion of Fausto Garcia & Associates (FGA) —that if CEMSA had claimed IEPS rebates in the proper amount, it would have had to increase its average price by 21% just to break even. A price increase of 50% —however improbable— would have resulted in a net profit margin of only 10% upon taking into account CEMSA's financing costs and a pro-rata allocation of its operating and administrative expenses, factors omitted by the Claimant's damages expert in his Reply opinion.

A. Response to the New Claim for "Lost Profits"[84]

210. At paragraph 76 of the Reply the Claimant contends, *inter alia*, "the Parties agree that the Claimant was pricing cigarettes below market". The Respondent has made no such admission. He further submits that he "could have sought to reduce the finance charges it (sic) paid to cover IEPS outlays". However, he does not offer any testimony as to what he would or could have done to obtain financing at lower rates, nor does he offer any testimony as to what he would or

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81. See Reply at paragraph 24.

82. Reply Witness Statement of Marvin Feldman at paragraph 5.

83. See Reply *Addendum to the Analysis of Damages to Corporacion de Exportaciones Mexicanas, S.A. de C.V.* by Ernesto Cervera Gomez (the "Cervera Addendum Report").

84. The evidence in support of this section is in the Rejoinder Witness Statement of Lic. Rolando Garcia Ramos, unless otherwise noted. [R 06457].

could have done to raise prices to establish a suitable profit margin if he had known that he was over-estimating the IEPS.

211. The Claimant's sole evidentiary rebuttal is based on Mr. Cervera's further opinion that, although he could not express an opinion on the legal issues relating to the IEPS law,

> ...(t)he fact is that CEMSA asked for and obtained IEPS rebates over a period of 16 months. (June 1996—September 1997). Thus, the entrepreneurial decision of setting the export price assumed that those IEPS rebates were going to be collected at the time. In any case, if the rebates were lower that the actual paid rebates, then the export price could have been higher, assuming entrepreneurial rationality. [85]

212. Mr. Cervera then opines that CEMSA's export price was lower than the average "implicit" price of overall Mexican exports to the countries that CEMSA exported to, claiming to rely on "data from official sources (Ministry of Economy)" that he does not disclose. In a footnote he simply explains that the average "implicit" price is calculated by dividing the value of exports by the volume of exports for each country.

213. Mr. Cevera presents a chart which purports to show the average "implicit" export price for five countries in Central America (but not the United States) and an unknown number of "non-declared countries", ranging from a low of 4.53 U.S. dollars (in the case of Nicaragua) to a high of 7.33 U.S. dollars (in the case of the non-declared countries). He then uses an "average implicit export price" of 6.14 U.S. dollars[86] to opine that if CEMSA had achieved this average price and received IEPS rebates in the amount calculated by FGA, "the profit margin would have reached 34.8%" in 1997.

214. As the Respondent will demonstrate below, it is not possible to determine the price per carton of cigarette exports to any country using the data Mr. Cervera claims to have relied on. The export data he claims to have used records the total declared value of each export transaction (usually based on the exporter's sales invoice to the importer) and the quantity of the shipment measured in kilograms, not the number of packages or cartons of cigarettes.

215. Moreover, a review of *Economia's* export data for 1997 shows that CEMSA shipped all (or substantially all) of the Mexican cigarettes exported to three of the named countries—Guatemala, Honduras and El Salvador. CEMSA's 1997 sales invoices show a range of actual average prices for these countries of 4.25 to 4.85 U.S. dollars per carton, not a range of 6.16 to 6.67 U.S. dollars as estimated by Mr. Cervera. His estimates are obviously incorrect.

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85. Reply, Cevera Addendum Report, at paragraph 7.

86. Cervera does not explain how he calculates the "average implicit export price" at 6.14 per carton. It is not the average of the implicit prices for various countries shown in his chart. Rather, it appears that he simply added 50% to CEMSA's stated average price of 4.09. (4.09 x 1.50 = 6.135)

The Claimant's Contrary Testimony

216. The Claimant has repeatedly testified and made submissions to the effect that "CEMSA could not export cigarettes without rebate of the IEPS tax because it could not find buyers for Mexican cigarettes at prices including the tax"[87]. He has testified that CEMSA typically paid Sam's Club 7.40 U.S. dollars per carton and that he resold the goods at prices averaging 4.05 U.S. dollars per carton[88]. He has also testified that after the alleged June 1995 agreement he "took months to develop suppliers, customers and financing"[89] —and that because of his "reputation in the business" he would know if any non-Mexican owned exporters were engaged in the cigarette export business[90]. This is wholly inconsistent with any suggestion that the Claimant was unwittingly pricing "below market" or that he could have imposed a 50% price increase (or any price increase) if he saw fit to do so.

217. It is significant that the Claimant's final witness statement is silent on the question of whether CEMSA could have increased its prices and whether he could have secured financing at lower interest rates. A review of CEMSA's actual pricing behavior in 1996 and 1997 shows that Mr. Feldman could not have testified credibly to facts that would support the submissions he now makes in paragraph 76 of the Reply or that would support the opinion now proffered by Mr. Cervera that, assuming "entrepreneurial rationality", the Claimant would have charged higher prices if he had known that CEMSA's actual entitlement to IEPS rebate was lower than the amount he was claiming.

Contrary Economic Theory

218. As explained in the Rejoinder Witness Statement of Lic. Garcia Ramos (an economist by education and training), Mr. Cervera's base assumption that "entrepreneurial rationality" would have caused CEMSA to raise prices in order to establish a suitable profit margin is wholly at odds with settled economic theory.

219. The presumed goal of a business enterprise is to maximize profits. The price of goods in a competitive market is determined by supply and demand—not by the seller or the buyer. Price is determined by the seller only in a monopolized market.

220. CEMSA did not have monopoly on supply, nor did it sell at below market prices in order to eliminate competition. None of the factors that cause or permit the continued existence of a monopoly apply to CEMSA.

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87. See Memorial Summary of Facts and paragraphs 5 and 70, and Memorial Declaration of Marvin Feldman at paragraph 6.

88. See Memorial at paragraph 7 and Memorial Declaration of Marvin Feldman at paragraph 6.

89. See Memorial at paragraph 69, and Memorial Declaration of Marvin Feldman at paragraph 52.

90 See Memorial at paragraph 135 and Memorial Declaration of Marvin Feldman at paragraph 95.

221. It thus defies settled economic theory for Mr. Cervera to presume that CEMSA, upon learning that it was over-claiming the IEPS, would simply raise its prices by 50% to make up the difference. This premise is facile and unsupportable, both in theory and in fact.

Contrary Export Data and Records

222. The export data maintained by *Economia* for cigarettes and other products is obtained from export *pedimentos*. It includes the tariff item number, a description of the goods according to the Harmonized Tariff Schedule, RFC (Mexican tax registry number), the exporting company's name, the exporting port, the destination of exported goods, their value in US dollars and their volume according to the measure established by the Harmonized Tariff System. In the case of cigarettes, the data field for the volume of goods being exported is measured in kilograms.

223. Efforts to convert volumes of cigarette exports from kilograms to cartons using an estimated ratio of "kilograms per carton" do not yield consistent results. There are many variables, including product mix, type of packaging and mode of transportation. For example some brands are packaged in mastercases of 60 cartons whereas other brands are sold 50 cartons to a mastercase, and the cigarettes themselves vary in weight, depending on the size and packaging of each brand. Moreover, the recorded weight can differ depending on whether the goods are shipped by air (in which case weights tend to be recorded very precisely) or by land or sea (in which case weights tend to be recorded in rounded figures).

224. Whatever methodology Mr. Cervera used to calculate "implicit" prices for Mexican cigarette exports in 1997, it cannot be empirically correct. *Ecomomia's* records show that CEMSA was the only exporter of cigarettes to Guatemala and Honduras, and was the exporter of 95% of Mexico's cigarette exports to El Salvador. Mr. Cervera's new theorem is completely refuted upon comparing CEMSA's actual average price for each of those countries (based on CEMSA's sales invoices for 1997) with his "implicit" prices (apparently based on data generated from export pediments reflecting prices stated in the same sales invoices):

CEMSA's % of total exports to country	CEMSA's actual average export price	Cervera's estimated "implicit" export price
Guatemala—100%	4.82	6.45
Honduras—100%	4.85	6.67
El Salvador—95%	4.25	6.16

225. It also bears noting that CEMSA's sales to customers in the United States (for which no "implicit" price is given) and to Guatemala, Honduras and El Salvador (where Cervera's "implicit" price is demonstrably wrong) accounted for 99.77% of CEMSA's cigarette sales in 1997.

CEMSA's Actual Pricing Behavior

226. The Claimant correctly alleges that about 70% of CEMSA's exports consisted of Marlboro cigarettes. About half of CEMSA's exports were shipped initially to two airports in the United States—Houston and Dallas-Fort Worth.

227. CIGATAM is the licensed manufacturer and distributor of Marlboro cigarettes in Mexico. CIGATAM does not and has not exported Marlboros or sold Marlboros to third parties for the purpose of export. CIGATAM reduced the price of Marlboro cigarettes twice in 1997 (on February 21 and November 17) to counteract the effects of trade in contraband cigarettes in the Mexican market[91].

228. Exhibit 1 to Lic. Garcia Ramos' Rejoinder Witness Statement is a graph illustrating CEMSA's sales of Marlboro cigarettes to customers in the United States in 1996 and 1997. As can be seen in the graph, CEMSA reduced its U.S. price for Marlboros immediately after CIGATAM lowered its price in February and November 1997. CEMSA's pricing for sales of Marlboros to Central America followed a similar pattern[92].

229. As Lic. Garcia Ramos observes, CEMSA's reaction to CIGATAM's price reductions points to the effects of either or both of two possible causes—competitive response and lack of demand at the existing price.

230. As to the first possible cause, one other cigarette reseller—Compañia Exportadora Mexicana—exported cigarettes to the U.S. in 1997, although its total sales were very modest. The Claimant could have feared competition from the Poblanno-Gámez-Guemez network, but on whole of the evidence it appears that they were collaborators in a common venture rather than competitors.

231. As to the second possible cause, the Tribunal can properly infer that CEMSA's customers were unwilling to buy except at a lower price because they were reselling the cigarettes in Mexico and had to compete in that market with CIGATAM's lower price for Marlboros. In other words, CIGATAM's reduction of the domestic price of Marlboros necessitated a reduction in CEMSA's export price of cigarettes that were circling through the U.S. back to Mexico.

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91. See Counter-Memorial Witness Statement of Noe Salazar Martinez [CM06070] at paragraph 25. See also *La Baja de Precios en los Cigarros Dañara Utilidades* (Lowering Prices for Cigarettes will Hurt Profits), Rachel Salaman, AP Dow-Jones (March 6, 1997) and *Mexican Tobacco Companies to Cut Prices to Battle Black-Market Goods*, Journal of Commerce (Nov. 25, 1997) p. 3A [both contained in Exhibit 2 of the Reply Witness Statement of Lic. Rolando Garcia Ramos].

92. CEMSA's sales of Marlboro to Central America followed a similar pattern.

Contrary Pricing Evidence from CIGATAM and La Moderna

232. Neither CIGATAM[93] nor La Moderna export the international brands that they produce under license in Mexico (*i.e.*, Marlboro and Raleigh, respectively), but they have exported certain Mexican domestic brands that were properly labeled for their country of destination at prices considerably lower than CEMSA charged its U.S. customers for Mexican domestic brands that were packaged and labeled for distribution in Mexico.

233. CIGATAM's figures cannot be compared directly with CEMSA's average prices because they do not reflect the same product mix. However, two Mexican domestic brands exported by La Moderna in the relevant time frame —Boots and Montana— were also exported by CEMSA to purchasers in the United States. La Moderna's average export price for Boots and Montana was 1.86 U.S. dollars per carton, substantially lower than CEMSA's average price of 2.30 U.S. dollars per carton for the same brands.

234. This further confirms that CEMSA was not pricing below market, at least for the domestic brands that it shipped to customers in the United States. It also raises the question as to why purchasers in the United States would pay CEMSA a higher price for gray market product than the producer's export price for the same goods.

235. The fact that these products cannot be sold in the United States because, among other reasons, they do not comply with U.S. labeling requirements, it supports the conclusion that the goods were being resold in Mexico. If there was a genuine market in a third country for cigarettes transshipped via the United States, surely the purchasers would have found the prices offered by La Moderna for products properly labeled for their country of destination to be significantly more attractive.

B. FGA's Rejoinder Report[94]

236. The FGA Counter-Memorial Report concluded that CEMSA's gross profit margin on cigarette sales, without taking financing costs into account, was only 2.2% if the IEPS rebate is calculated correctly. With financing costs factored in there was a negative margin—minus 7.3 %. FGA noted that the loss would be greater if operating and administrative expenses were to be considered. However, having concluded that CEMSA's cigarette exports produced a negative cash flow (if the IEPS rebate is calculated correctly), FGA did not find it necessary to consider the effect of CEMSA's operating and administrative expenses.

237. In concluding that CEMSA could have enjoyed a "profit margin" of 34.8% in 1997 (claiming IEPS rebates in the proper amount) by increasing its average price by 50%, Mr. Cervera does not take into account CEMSA's financing costs or any of its operational expenses. The figures used for his various "conservative", "intermediate" and "aggressive" scenarios for

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93. References to CIGATAM include (where appropriate) Philip Morris Mexico, which assumed responsibility for commercializing CIGATAM's products in August 1997. See the Counter-Memorial Witness Statement of Noe Salazar Martinez, Controller of CIGATAM.

94. See Report of Fausto Garcia & Associates, S.C. dated June 22, 2001 [RXXX.]

alleged loss of profits are based on an assumed bare profit margin that does not take into account any expenses other than the bare cost of goods.

238. As noted above, Mr. Feldman does not offer any testimony as to how he could have increased prices, and neither he nor Mr. Cervera offer any evidence as to how CEMSA would have carried on business without the loans the Claimant says he obtained from Dr. Zagorin and Messrs. Poblanno and Gamez.

239. FGA was asked to address the following points in its Rejoinder Report:

a) first, to calculate CEMSA's net profit margin on cigarette exports in 1996 and 1997, taking into account a pro-rata allocation of operating and administrative expenses and then to separately apply (i) the financing expenses CEMSA claims to have incurred and (ii) the estimated financing expenses a typical creditworthy trading company would incur for conventional financing from an institutional lender (the "Historic Average Price Scenario");

b) second, to calculate the increase in average price CEMSA would have had to achieve in 1996 and 1997 in order to break even on cigarette exports, taking into account a pro-rata allocation of operating and administrative expenses, separately applying (as above) (i) CEMSA's actual financing expenses and (ii) conventional financing expenses (the "Break Even Scenario"); and

c) third, to calculate CEMSA's net profit margin on cigarette exports in 1996 and 1997 on the assumption that CEMSA's average price in both years could have been increased by 50%, again separately applying (as above) (i) CEMSA's actual financing expenses and (ii) conventional financing expenses (the "Cervera Scenario").

240. For the "Historic Average Price Scenario", FGA's Rejoinder Report concludes that CEMSA's net profit margin on cigarette exports was as follows:

Year	Net Profit Margin with CEMSA's Financing	Net Profit Margin with Conventional Financing
1996	Minus 11.1%	minus 8.2%
1997	Minus 19.6%	minus 12.4%

241. For the "Break Even Scenario", FGA's Rejoinder Report concludes that, just to break even, CEMSA would have had to achieve an increase in its average price on cigarette exports as follows:

Year	Increase to Break Even with CEMSA's Financing	Increase to Break Even with Conventional Financing
1996	11.3%	8.1%
1997	21.1%	13.0%

242. For the "Cervera Scenario", FGA's Rejoinder Report concludes that if CEMSA had been able to increase its average price by 50% and maintain the same level of sales, its net profit margin would have been as follows:

Year	Net Profit Margin with 50% Increase in Average Price and CEMSA's Financing	Net Profit Margin with 50% Increase in Average Price and Conventional Financing
1996	14.3%	16.0%
1997	10.1%	13.2%

243. In providing figures for CEMSA's net profit margin with conventional financing expenses the Respondent does not acknowledge that CEMSA could have obtained financing on commercial terms from an institutional lender. The interest rate used by FGA is based on its estimation of interest rates paid by creditworthy trading companies operating in Mexico at the material time.

244. The Claimant's failure to adduce any evidence as to what other sources of financing were or could have been available to finance CEMSA's "cigarette export business" should be dispositive of the issue.

245. In providing figures for CEMSA's net profit margin based on a 50% increase in CEMSA's average price, as postulated by Mr. Cervera, the Respondent does not acknowledge that the Claimant could have increased prices at will to achieve a 50% increase or any increase. As demonstrated above, the hard evidence refutes the suggestion that CEMSA was pricing "below market". Again, the Claimant's failure to testify as to what he could have done to increase prices or otherwise improve CEMSA's profit margin should be dispositive of the issue.

246. The Respondent has submitted evidence as to what net profit CEMSA might have earned if conventional financing was available, or if Mr. Feldman could have increased prices at will, to demonstrate that (i) CEMSA's cigarette export business was far from profitable in any event and (ii) the revised claim for damages —now based on the unrealistic assumption of a 50% price increase— is still exaggerated in its failure to account for any expenses other than the bare cost of goods.

C. Response to Paragraph 77 of the Reply[95]

247. In paragraph 77 of the Reply the Claimant contends that his damages calculation in the Memorial is understated, particularly for 1996, "because a number of invoices cannot be located". He says that "Respondent understates CEMSA's cigarette purchases in 1996 in calculating the IEPS at 103%" (referring to Table 5 of Lic. Garcia Ramos' first witness statement). He now contends that "the invoices produced to Respondent show cigarette purchases of 36 million pesos in 1996, and these may be incomplete".

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95. The evidence in support of this section is in the Rejoinder Witness Statement of Lic. Rolando Garcia Ramos [R 06457], unless otherwise noted.

248. As explained in Part B of Lic. Garcia Ramos' Reply Witness Statement, his calculation of CEMSA's cigarette purchase was based on all available purchase invoices—those obtained by SHCP in the 1998 audit and those produced by the Claimant in the arbitration. His total is about 10% higher that the total given by the Claimant's auditor, Mr. Zaga, who reported 1996 cigarette purchases of 22,431,338 pesos.

249. All available records contradict the new allegation that CEMSA purchased and exported 36 million pesos worth of cigarettes in 1996. *Economia's* export data conforms closely with Mr. Zaga's figure for export sales. By extrapolating it can be seen that CEMSA's cigarette purchases in 1996 totaled about 22 million pesos.

250. Mr. Zaga's figure for 1996 export sales is 1,507,782.00 dollars (11,631,361.54 pesos). Lic. Garcia Ramos' figure for 1996 export sales (based on sales invoices recorded in the data base) is 1,615,006.00 dollars (12 million pesos). *Economia's* data base shows CEMSA's 1996 cigarette exports as 1,425,556 dollars (10.9 million pesos).

251. Using CEMSA's average discount between the price it paid to Sam's Club for cigarettes and the price it charged its customers, it can be seen that total sales of 1.4 million dollars indicates about 2.74 million dollars in cigarette purchases. Expressed in pesos, total sales of 10.9 million pesos indicates total cigarette purchases of about 21.2 million pesos, approximating the amount that Mr. Zaga calculated from CEMSA's purchase invoices.

252. For CEMSA to have purchased and exported cigarettes costing 36 million pesos in 1996, its total sales figure for 1996 would have to be about 18.6 million pesos, about 60% greater than its own records and *Economia's* data base indicate.

253. For CEMSA to have been entitled to the 23.07 million pesos it actually claimed and received for 1996, using its own formula for calculating the IEPS (as per Mr. Zaga's report) it would have to show cigarette purchases totaling about 44 million pesos. Using the correct formula for calculating the IEPS, it would have to show cigarette purchases totaling about 51.3 million pesos. The Claimant has produced purchase invoices totaling only 24 million pesos.

254. Lic. Garcia Ramos' calculations in support of paragraph 206 of the Counter-Memorial—that the IEPS rebates CEMSA claimed and received for 1996 amount to 96% to 103% of its 1996 cigarette purchases—stand unrebutted. The Claimant submitted claims for IEPS rebates that were grossly excessive in 1996 as well as 1997.

D. Concluding Remarks on Damages

255. The Claimant has not made any effort to show that the either of the methodologies he says he used for calculating IEPS rebates is correct, or that the results bear any resemblance to the actual amount of IEPS contributed to the Treasury by the producers of the products that CEMSA exported. He contends only that he cannot be faulted for not knowing the correct figures.

256. The Respondent submits that any assessment of lost profits—past or future—can only be based on CEMSA's actual entitlement to IEPS rebates on the goods it exported, not the amount

the Claimant thought he could claim, or that he temporarily succeeded in claiming, whether such was the result of honest mistake or deceit.

257. The Respondent has proven that CEMSA could not have profitably engaged in its so-called "cigarette export business" if the Claimant had submitted requests for IEPS rebates in the proper amount. This is a simple point that the Tribunal can confirm for itself using the Claimant's own numbers.

258. The Claimant says CEMSA's average cost of cigarettes was 7.40 U.S. dollars and that its average sale price was 4.05 U.S. dollars. Even if the price paid to Sam's Club was equal to the wholesale price of the goods (the *precio al detallista*), upon extracting the IEPS using the correct formula (by subtracting the purchase price divided by 1.85 from the sales price[96]), the gross profit on each carton sold was only five cents, without taking into account any other expenses.

259. The Respondent has also demonstrated that Mr. Cervera's new contention—that CEMSA could have enjoyed a reasonable profit simply by imposing a 50% price increase—is at best wishful thinking. There is no credible evidence to support this proposition but ample evidence to establish the opposite conclusion—that the Claimant was already charging the highest price that he could obtain.

260. "Entrepreneurial rationality" did not cause Mr. Feldman to attempt to resolve CEMSA's profitability problem by increasing prices or by reducing CEMSA's financing costs. Instead he attempted to maximize profits by changing his methodology for calculating the IEPS rebate, almost doubling the IEPS rebate on every sale.

261. No fair and rational assessment of the fair market value of CEMSA's cigarette export business or its alleged loss of profits could presume that prices could be increased to achieve profitability. This applies equally to the period when the Claimant alleges CEMSA was unlawfully kept out of the cigarette export business (January 1994 to May 1996), the period when CEMSA was engaged in the cigarette export business (May 1996-November 1997), and the period when the Claimant alleges that one or more Mexican-owned entities in like circumstances to CEMSA were permitted to claim IEPS rebates on cigarette exports (1999-2000).

262. Nor could any fair and rational assessment of CEMSA's alleged loss of goodwill or other intrinsic value ignore the fact that no *bona fide* purchaser would have any genuine interest in acquiring the company or its cigarette export business if imputed with knowledge that its existence depended, even in part, on the resale of its ostensible exports in Mexico. No right thinking person would choose to engage in such activity.

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96. $4.05 - (7.40 \div 1.85) = 0.5$.

VII. PUBLIC POLICY

263. The Reply did not attempt to respond to the Counter-Memorial's public policy submissions.

264. The Tribunal is now presented with irrefutable evidence as to the true nature of this trade. Wittingly or unwittingly, the Claimant and his company were participants in an enterprise to export cigarettes with the aid of IEPS rebates and then to return them to Mexico.

265. It is respectfully submitted that this Tribunal cannot reward a participant in such an enterprise. To do so would bring NAFTA and Chapter Eleven into disrepute.

266. In legal disputes between states, the claimant State has a duty to advance its claim in the utmost good faith. In the Respondent's submission, since a private party steps into the place of a State under Chapter Eleven, the same duty of good faith must apply. As Bin Cheng stated in *General Principles of Law*:

> A state, first of all, has the right to expect from another that "no claim will be put forward that does not bear the impress of good faith and fair dealing on the part of the claimant" [97].

267. In the case of arbitrations between states, it has been said that:

> Qu'il s'agisse du règlement judiciaire ou du règlement arbitral, on s'accorde à reconnaître qu'il existe à la charge de l'Etat, une obligation générale d'agir de bonne foi [98].

268. Zoller elaborates on this statement by quoting the international jurist, Paul de Visscher, who as counsel for Honduras in the case of the *Arbitral Award made by the King of Spain on December, 1906*, stated that:

> Dès l'instant où deux Etats s'engagent à régler un différend sur la base du droit et à la base du droit et à la plus entière loyauté. Dès ce moment, ils doivent savoir que leurs déclarations, leurs attitudes, leurs comportements pourront être retenus contre eux. La justice, à la différence de la politique, ne s'accommode pas de faux-fuyants, de déclarations équivoques, de réserves mentales. La justice vit de sécurité, et s'il en est ainsi, c'est en définition parce que la fonction judiciaire est, au tout premier chef, une fonction sociale. Elle existe dans l'intérêt général autant que dans l'intérêt des parties [99].

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97. Bin Cheng, *General Principles of Law*, at p. 159.

98. "Whether it is a question of judicial or arbitral regulation, the State is under a general duty to act in good faith". *Ibid.*, p. 123.

99. "From the moment that two States agree to settle differences according to the law and with the intervention of a judge, they have bound themselves to act with total loyalty. From that moment, they have to understand that their declarations, attitude and actions can be held against them. Justice, as opposed to politics, does not accommodate prevarication, ambiguous statements, mental reservations. Justice lives by security, and if it so, it is because the judicial function is, first and foremost, a social function. It exists for the general interest as much as for the benefit of the parties." Zoller, *supra*, p. 123.

269. "Les Etats, parties à une procédure internationale, ont le devoir de collaborer de bonne foi dans l'établissement des preuves"[100]. This principle was referred to in the case of the *Lehigh Valley Railroad Company*[101], in which the Commission declared:

> It is well recognized that governments who have agreed to arbitrate, are under an obligation in entire good faith to try to ascertain the real truth.

270. Given the relative lack of mechanisms for the establishment of facts in international arbitrations, the obligation of good faith is all the more important:

> La bonne foi est donc un élément fondamental du mécanisme de la preuve. Le juge ne peut décider que sur la base d'une collaboration sincère entre les parties et lui-même [102].

271. The Respondent submits that the Tribunal can find under Article 1131 that a duty of good faith is owed by a private investor who seeks to invoke Chapter Eleven and that an investor who —wittingly or unwittingly— is engaged in an enterprise designed to evade the taxation and customs laws of a NAFTA Party cannot be permitted to call Chapter Eleven into aid of his activities.

VIII. THE ALLEGED ACTS OF HARASSMENT AND INTIMIDATION

272. The Claimant has at various times alleged that the Respondent has engaged in acts of harassment and intimidation against him. Most of such acts concern actions by SHCP in the legitimate exercise of its powers to tax and enforce taxation laws.

273. In the Respondent's submission, the Claimant has abused the Chapter Eleven Section B dispute settlement mechanism in an attempt to escape the application of Mexican tax laws against him. He has done so since the beginning of the proceeding when in his submission of 15 February 2000 he first requested that the Tribunal issue provisional measures of protection and order the Respondent "immediately to cease and desist for the duration of this arbitration from any interference with Claimant or his property or with CEMSA's assets or revenues, whether by embargo or by any other means".

274. On 18 January 2001 the Claimant requested yet another order from the Tribunal in connection to a request for information by SHCP concerning a personal audit of Mr. César Poblanno. The Claimant asserted that "Hacienda's audit of Mr. Poblanno initiated after his activities became an issue in these proceedings, could be seen as an effort to intimidate a potential witness". The Respondent submits that that was also an attempt to avoid being

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100. "States which are parties to an international proceeding are under a duty to co-operate in good faith in order to ascertain the facts." Charles de Visscher, *Problèmes d'interprétation judiciaire en droit international public*, Paris, 1963, p.34.

101. *Recueil des sentences arbitrales*, Vol. VIII, p. 85.

102. "Good faith is thus a fundamental element in the mechanism of proof. The judge can make his decision only upon the basis of sincere co-operation between the parties and himself." E. Zoller, *supra*, p. 149.

investigated in relation with someone who the Respondent has shown was, in fact, a close business partner of the Claimant in the so-called cigarette export business.

275. In the Memorial, the Claimant asked the Tribunal to

> rule that Respondent is estopped from challenging CEMSA's right to IEPS rebates on cigarette exports in 1996-1997 and ... [that] Respondent should be barred from asserting those claims against CEMSA either in the Mexican courts or as a set-off against execution of an award by this Tribunal... [as well as] (1) a declaration that Respondent is not entitled to recover IEPS rebates paid to CEMSA in respect of cigarette exports in 1996-1997, and (2) a contingent award of damages in the amount of any tax assessment by Respondent against CEMSA in connection with the IEPS rebates it received on cigarette exports in 1996-1997. [103]

276. This is no more than another attempt to escape liability under Mexican tax laws. As noted in the Respondent's submission of 6 March 2000,

> This specific case involves matters relating to compliance with the law, the authority of Mexican officials to conduct audits with respect to situations in which they consider that the procedures have been abused in order to unduly obtain a benefit, and the consequent determination of tax liability. It raises very serious questions in respect of which the appropriate Mexican authorities have an obligation to act in order to safeguard compliance with the law and protect the public treasury.

277. The Responded then also stated "The Government of Mexico intends to present evidence that CEMSA has abused the tax rebate system in order to unduly obtain benefits". The Respondent has presented this evidence. The record shows that SHCP has acted not only in good faith, in exercise of its powers to impose and collect taxes and enforce tax laws, but prudently in light of the evidence of the Claimant's actions.

278. The Claimant has not acted in good faith. He abused the tax rebate mechanism by causing CEMSA to claim and obtain rebates to which it did not have a right. He knowingly overstated IEPS rebate claims. He claimed rebates for purchases made by others. He participated in a scheme where the cigarettes he claimed to have sold "for export only" to the U.S., according to his invoices, were shipped to El Paso with his knowledge, and then shipped back to Mexico. He claimed rebates for exports made to fictitious companies in Central America. He submitted false documents and information to Mexico's tax authorities.

279. The Claimant has tried to embarrass and put pressure on Mexican officials by making unfounded accusations of illegality and criminal conduct against them in newspaper advertisements, and by filing criminal complaints against individual officials, which complaints were dismissed for lack any evidence of wrongdoing.

280. The Claimant also has been far less than forthcoming in presenting his case: he has failed to inform the Tribunal of key facts; he has failed to put in complete evidence; he has continuously misrepresented the evidence.

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103. Memorial at paragraphs 247 and 248.

281. The Tribunal should not allow such an abuse of Chapter Eleven.

IX. CONCLUSION

The Respondent respectfully reaffirms its request that the claim be dismissed with costs awarded to the Respondent.

All of which is respectfully submitted

[signed in the original]

Hugo Perezcano Diaz

Consultor Juridico