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The United States–Mexico–Canada Agreement: Energy Production and Policies

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INTRODUCTION

Energy is one of Mexico's largest exports, ranking behind only motor vehicles and machinery in dollar terms.[1] However, production has steadily decreased in recent years, from an average of about 3.4 million barrels per day (bpd) in the early 2000s to about 1.7 million bpd by November 2018.[2] Foreign (and other private) investment in the energy sector was restricted to the Mexican state until 2013–14. Then, with a series of more than 21 legislative changes and three amendments to Mexico's Constitution,[3] led by the Peña-Nieto administration and the Institutional Revolutionary Party (PRI) but supported as well by the National Action Party (PAN) and the Party of the Democratic Revolution (PRD, President Andrés Manuel López Obrador's former party), the reforms were intended in significant part to support the enactment of financial, education, telecommunications, and fiscal reforms.[4] The success of the López Obrador presidency may well depend on his energy policies, including his treatment of the bloated, inefficient state-owned oil company, Pemex, and the ability to continue to attract foreign investment in the hydrocarbons sector. Because energy exports are a major source of foreign exchange for Mexico, maintaining and increasing energy export earnings are critical to generating the revenues AMLO will require to carry out many of his domestic reforms, including those designed to improve the lives of Mexico's poor.

The focus of this report is on the challenges posed by the energy reforms undertaken by the previous administration; the limitations the United States-Mexico-Canada Agreement[5] imposes on changes in Mexico's energy policies (such as restricting investment in the sector); other USMCA provisions that could affect energy; and a critique of AMLO's early energy-related policy decisions. It also includes a summary of changes in the legal treatment of U.S.-Canada energy relations under the USMCA compared to Chapter 6 of the North American Free Trade Agreement. The report ends with a short conclusion.

MEXICO'S ENERGY REFORMS AND AMLO'S CHALLENGES

Key elements of the reforms overwhelmingly approved by Mexico's Congress included:

- Maintaining state ownership of subsoil hydrocarbons resources, but allowing companies to take ownership of those resources once they are extracted and to book reserves for accounting purposes;
- Creating four types of contracts for exploration and production: service contracts (companies are paid for

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activities done on behalf of the state), profit-sharing contracts, production sharing contracts, and licenses (enabling a company to obtain ownership of the oil or gas at the wellhead after it has paid taxes);

- Opening the refining, transport, storage, natural gas processing, and petrochemicals sectors to private investment;
- Transforming Pemex into a productive state enterprise with an autonomous budget and a board of directors that does not include union representatives;
- Strengthening four federal entities with regulatory roles in the hydrocarbons industry (the Ministries of Energy and Finance, the National Hydrocarbons Commission or CNH, and the Energy Regulatory Commission) and creating a National Agency for Industrial Safety and Environmental Protection; and
- Establishing a sovereign wealth fund, the Mexican Petroleum Fund for Stabilization and Development, to be managed by the Central Bank.[6]

While actual exploration and development has been hampered by fluctuating oil prices in recent years,[7] the prospects for Mexico in the medium and long term are generally bright. Because of low prices, only two of the original 14 blocs found bidders in 2015.[8] Less than three years later, in January and March 2018, more than 70 different firms made over $100 billion in new oil investment commitments, important revenue for a government that seeks sweeping social changes.[9] However, whether an increase in oil production, an influx of capital to Pemex, and reforms to foreign investment in Mexico's energy sector can all be achieved during AMLO's sexenio remains uncertain due to factors both within and beyond his control, as discussed in this report.

The challenge in my view is enormous. The statutory and constitutional energy reforms engineered by former President Enrique Peña-Nieto, if and only if they are supported by AMLO, offer Mexico an opportunity to re-energize its declining petroleum sector by encouraging foreign oil companies, including but not limited to those located in the United States, to go forward with their investments and exploration—which have frequently been postponed since 10 leases were awarded in 2017,[10] first because of relatively low world oil prices but also because of uncertainties as to what AMLO's energy policies will entail. This could encourage investment in Mexico's oil sector to go forward, despite the fact that world oil prices have fluctuated recently from above $75 per barrel to as low as $41 per barrel.[11] Still, despite the legal constraints discussed below, it is still possible that AMLO, who distrusts the energy overhaul[12] and has a supermajority in the Mexican Congress, could seek to roll back the Peña-Nieto administration's energy reforms. (If this occurs, the leases awarded in the past to U.S. or Canadian enterprises could be subject to challenge under the dispute settlement provisions of NAFTA Chapter 11 for up to three years after the USMCA enters into force.) Dealing with Pemex's institutional problems, including a $108 billion debt, will also affect future oil and gas production.

This report further observes that many of the domestic promises AMLO made during his campaign and is now seeking to implement, including those related to improving education and combating endemic corruption and violence, are largely dependent on AMLO's ability to encourage investment in and gain revenue from the hydrocarbons sector, which would permit Mexico to increase its oil and gas exports in the future. Even though the major impact of such investment is not likely to be felt directly during AMLO's sexenio, income from new leases alone could soon provide some of the funding for AMLO's promised reforms. Thus, if the AMLO administration fails to encourage and protect new investment in the petroleum sector, in my view his sexenio will be a failure, and will probably result in a level of social and political instability that Mexico has not seen in many decades.

USMCA LEGAL CONSTRAINTS ON MEXICO'S ENERGY POLICIES

Despite the liberalization of the petroleum sector beginning in 2013 by the Peña-Nieto administration, USMCA Chapter 8 specifies that:

> 2. In the case of Mexico, and without prejudice to their rights and remedies available under this agreement, the United States and Canada recognize that:
>
> (a) Mexico reserves its sovereign right to reform its Constitution and its domestic legislation; and
>
> (b) The Mexican State has the direct, inalienable, and imprescriptible ownership of all hydrocarbons in the subsoil of the national territory, including the continental shelf and the exclusive economic zone located outside the territorial sea and adjacent thereto, in strata or deposits, regardless of their physical conditions pursuant to Mexico's Constitution.[13]

Does this mean that the Lopez-Obrador administration could roll back the 2013 reforms to Mexico's energy law permitting foreign investment in the sector? No, because there are other constraints in the USMCA to AMLO's treatment of energy beyond those included in Chapter 8, even though the legal structure of Mexico's obligations is complex. The United States' view is that the Chapter 8 language essentially states the obvious: any sovereign state retains the right to change its constitution and laws, even if such changes may incur international responsibility to treaty partners. In other words, under the USMCA, limitations exist on AMLO's legal authority to Mexico's petroleum laws and policies.

This analysis begins by noting that Mexico did not take any specific reservations in its USMCA obligations that would affect investment in the energy sector beyond the stating-the-obvious language in Chapter 8. However, Mexico agrees in the USMCA to a type of "most-favored-nation" clause, agreeing to afford other parties (as well as service providers and state-owned enterprises) treatment regarding energy that is no more restrictive than treatment Mexico grants to parties of other trade agreements Mexico has concluded. The key USMCA provision is as follows:

> Article 32.11: Specific Provision on Cross-Border Trade in Services, Investment, and State-Owned Enterprises and Designated Monopolies for Mexico
>
> With respect to the obligations in Chapter 14 (Investment), Chapter 15 (Cross-Border Trade in Services), and Chapter 22 (State-Owned Enterprises and Designated Monopolies), Mexico reserves the right to adopt or maintain a measure with respect to a sector or sub-sector 32-12 for which Mexico has not taken a specific reservation in its schedules to Annexes I, II, and IV of this agreement, *only to the extent consistent with the least restrictive measures that Mexico may adopt or maintain under the terms of applicable reservations and exceptions to parallel obligations in other trade and investment agreements that Mexico has ratified prior to entry into force of this agreement, including the WTO agreement,* without regard to whether those other agreements have entered into force.[14] (emphasis added)

Under this clause, Mexico must afford treatment to the United States and to U.S. investors in sectors covered in the three chapters of USMCA listed above that is no less favorable than treatment Mexico has offered in parallel trade and investment agreements. This is a clear reference to the Comprehensive and Progressive Trans-Pacific Partnership Agreement (CPTPP), which was signed by Mexico in March 2018 and went into force for Mexico and six of the 10 other CPTPP parties on December 30, 2018.[15] It would have been preferable in my view that a reference to Chapter 8 be included in the list in Article 32.11, but if Article 14 (investment protection) is included it probably does not matter.

Mexico can liberalize the restrictions on foreign investment contained in the Pena-Nieto reforms and Annex I without violating either the CPTPP or the USMCA (incorporated through Article 32.11), but it cannot make the rules more restrictive.

In the CPTPP/TPP, Mexico listed several specific energy-related reservations.[16] Those reservations permit foreign investment in the sector under the conditions set out in the 2013 legislation enacted by the Pena-Nieto administration, barring any less favorable treatment. Thus, under the proviso quoted above, incorporating the energy reservations agreed to by Mexico in the CPTPP, the Lopez-Obrador administration (and any subsequent Mexican governments) may not make the rules under which foreign investment is permitted in the energy sector any more restrictive than those set out in the CPTPP annexes.

To reiterate, the Pena-Nieto energy reforms are directly incorporated into CPTPP Annex I-Mexico-17 through Annex I-Mexico-27 [page numbers in each case]. The effect of this is to make them binding obligations toward the other 10 CPTPP parties: Mexico can liberalize the restrictions on foreign investment contained in the Pena-Nieto reforms and Annex I without violating either the CPTPP or the USMCA (incorporated through Article 32.11), but it cannot make the rules more restrictive. In other words, the minimum level of treatment of foreign investment in Mexico's energy sector is established through these annexes. And through the operation of USMCA article 32.11, these are the most restrictive measures Mexico may take in its relations with the United States under the USMCA (and with Canada, although because Canada is a CPTPP party, it directly has the protections outlined under Annex I of that agreement). Article 32.11 was thus included at the behest of U.S. negotiators to protect U.S. energy sector investors in Mexico, now and in the future.

This analysis was confirmed by the Office of the U.S. Trade Representative.[17] Also, in an interview with USTR officials, I was assured that members of Mexico's USMCA negotiating team, including AMLO's representatives, fully understand the commitments incorporated through these provisions. While the legal case seems solid to me, I have some uneasiness that when the analysis is widely publicized—as is inevitable when hearings on the USMCA are held in the U.S. House and Senate and in the Mexican Congress—some backlash may occur in Mexico. Still, one can easily understand why AMLO, whose representatives participated in negotiations several months prior to his inauguration, did not want to include a straight-forward commitment in USMCA Chapter 8 precluding any rollback of the Pena-Nieto energy reforms, even if he had no intention of doing so at that time. If AMLO had misgivings about permitting further foreign investment in the energy sector in the future, he need only do what he has already done—that is, establish a three-year moratorium on new leases, as discussed below.

The USTR appears to have been equally effective in taking into account the views of members of the industry advisory committee throughout the complicated analysis summarized above. They noted in their report that "In combination, we believe that Chapter 8 and Chapter 32/ Article 11 and the horizontal provisions of the rest of the USMCA all work together to commit Mexico, Canada, and the U.S. to energy markets that are open to trade with each other and open to investment from each other."[18]

INVESTOR PROTECTIONS IN MEXICO'S PETROLEUM SECTOR

As discussed in an earlier report in this series,[19] the USMCA's Chapter 14 on investment protections reduces protections for investors in most sectors compared to NAFTA's Chapter 11. Changes include eliminating claims for violations of fair and equitable treatment and for pre-investment discrimination, as well as imposing an exhaustion of local remedies requirement before an investor may seek international arbitration. However, Chapter 11-like protection[20] is maintained entirely for several sectors that were apparently deemed sensitive and for which both the Mexican and U.S. governments and U.S.

stakeholders wished to assure investor protections. These included oil and gas, and electric power production.[21] Thus, for the energy sector, investor-state dispute settlement (ISDS) protection not only includes national treatment, most-favored-nation treatment, and protection against direct expropriation, but also guarantees of fair and equitable treatment and protections against indirect expropriation.[22] In addition, the exhaustion of local remedies requirement does not apply to energy.

It is evident that a major objective of this coverage, which was accepted by the then-incoming AMLO administration as well as the Trump and Peña-Nieto administrations, is to give American petroleum and natural gas investors a strong sense of confidence in Mexico. It provides investors assurance that should a dispute arise—for example, between the investor and Pemex under an exploration contract or lease—the investor would have the recourse normally expected under investment chapters such as NAFTA Chapter 11 and the 35 bilateral investment treaties Mexico has concluded with other third parties ranging from the United Kingdom to China.[23]

For Canadian investment in Mexico's oil (or other energy) sectors, the two parties and their affected stakeholders could also rely on Chapter 9 of the CPTPP, with certain limitations on the scope of coverage of investment agreements under the original Article 9.1 of the CPTPP.[24] As I read these provisions, ISDS under Chapter 9 of the CPTPP would not be available to Canadian investors that had concluded "investment agreements" with Mexican entities such as Pemex unless those agreements specifically provided for ISDS. (Subsidiaries of Canadian energy firms operating in the United States, or in third countries where bilateral investment treaties with Mexico were in force, would be protected.)

It is notable that the Energy Sector Advisory Committee expressed disappointment at the breadth of ISDS in the USMCA:

> The existing NAFTA agreement included a full suite of ISDS investor provisions that protected current and future United States investment in Canada and Mexico. It allowed the United States energy industry to mitigate the risks associated with large-scale, capital-intensive, and long-term projects. The new renegotiated agreement with Mexico has scaled back those ISDS provisions considerably. While it is greatly appreciated that the major importance of the trade agreement with Mexico and potentially Canada, ISDS protections for the oil & gas, infrastructure, energy generation, and telecommunications sectors has been recognized and added to the new agreement, we would further recommend that a more inclusive list of energy sources receive the full suite of protections to help mitigate investment risk.[25]

APPLICABILITY OF USMCA CHAPTER 11 TO ENERGY

A decision by the AMLO administration to roll back the 2013 energy reforms would not in itself be a violation of the USMCA's technical barriers to trade (TBT) provisions, which by nature are procedural rather than substantive. Chapter 11 "applies to the preparation, adoption, and application of standards, technical regulations, and conformity assessment procedures, including any amendments, of central level of government bodies, which may affect trade in goods between the parties." Changes in technical regulations require that preference be given to international standards and that parties provide a written explanation of any other standard used, with an obligatory exchange of information, consultation, and a high level of transparency. The preference is always toward conformity with international standards and avoidance of regulations that unduly restrict trade, with the other parties to the agreement maintaining the right

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to seek a less trade-restrictive method to fulfill the regulation's objective, including one based on an international standard.

The TBT chapter thus has only limited applicability to oil and gas issues. For example, if Mexico (or the United States) proposed a regulation requiring that gasoline contain 15% ethanol (instead of the current 10% standard), the other party could invoke the TBT procedures. However, in the unlikely event that Mexico would roll back the current petroleum laws, the TBT agreement would only be a legal hurdle procedurally. TBT's most valuable provisions are those related to consultation and transparency, giving each party the opportunity to discourage another party from issuing regulations that restrict trade.

AMLO'S QUESTIONABLE PETROLEUM POLICIES

Several actions by the AMLO administration have raised questions about the nature of AMLO's foreign investment and administrative policies, including but not limited to petroleum production. Perhaps most significantly, the then-incoming AMLO government announced in late November 2018 that Mexico would suspend further bidding for oil and gas exploration leases until 2021.[26] The reasons for this decision are not entirely clear, but it appears that the administration wishes to have time to review existing leases for evidence of corruption or other irregularities. Regardless of any justification, the result could be to significantly reduce or eliminate income from the sale of leases during the first half of AMLO's sexenio, foregoing a significant source of potential revenue to finance his ambitious reforms and fulfill campaign pledges.

As of spring 2019, the shock of President-elect AMLO's decision to abandon the $13 billion new Mexico City airport project in October following a so-called referendum[27] had not yet fully dissipated, even though it appeared that at least $1.8 billion of the $6 billion in bonds issued to fund the project would be bought back from investors at par plus accrued interest.[28]

The energy sector in the medium and longer term may also be affected by uncertainties surrounding AMLO's commitment to spend some $8 billion on a gasoline refinery ("Dos Bocas") along with the administration's efforts to reduce gasoline imports from the United States by about 28% from 2018 levels.[29] The refinery project has created additional skepticism for investors due to the administration's decision in early May 2019 to abandon the effort to solicit financing from private companies that had qualified for the initial bidding process (such as Bechtel, Techint, and WorleyParsons). Instead, AMLO indicated that Pemex would undertake the construction on its own using Mexican instead of international design firms.[30] Whether this step results in cost savings or a loss of money due to Pemex's lack of competence or corruption within the organization remains to be seen. Observers note that upgrades to Mexico's gasoline refineries promised in the early 2000s have never been completed, and that the country's existing refineries are operating at only about one-third of their capacity.[31]

A more general concern is AMLO's less-than-rational commitment to an entity—Pemex—that is in serious financial straits, said to be the world's most indebted oil company with total debt of about $108 billion.[32] He has also provided Pemex with $1.3 billion in new tax breaks over six years, causing some observers to warn that the fragility of Pemex's economic situation could affect the federal government's ability to borrow more broadly.[33]

Also, AMLO took steps in January 2019 to reduce chronic theft of petroleum products from pipelines, mostly by criminal gangs (a problem ignored by Pemex under previous administrations), which totaled more than $3 billion in 2018.[34] Though it was a worthy objective, by shutting down the pipelines and endeavoring to deliver gasoline to filling stations by tanker trucks, the administration caused long lines in several parts of the country and unhappiness among many citizens who needed fuel for business purposes in particular.[35] None of these actions related to the energy sector has reduced the strong popular support in Mexico for AMLO, however, who enjoys a 72% approval rating as of early June.[36] A more recent cause for investor uncertainty is the inclusion in Mexico's 2020 budget of an assumption that Pemex will be able to increase oil production to 1.951 million barrels per day, a level that has not been achieved since 1982.[37]

UNITED STATES AND CANADA'S AGREEMENTS ON ENERGY

While NAFTA Chapter 6 specified few obligations for Mexico, it imposed restrictions on energy trade between the United States and Canada. This included a ban preventing Canada from reducing exports to the United States below the portion of total domestic demand in the past three years.[38] In other words, Canada could not reduce petroleum exports to the United States unless it also reduced domestic consumption of Canadian oil. The ability of these two parties to invoke national security grounds to limit petroleum exports or imports was also circumscribed.[39]

Although the United States has in the past 25 years become the world's largest oil producer,[40] its energy relationship with Canada was sufficiently important to both parties that they concluded a side letter/agreement to the USMCA on energy. However, that agreement departs significantly from NAFTA Chapter 6. The USMCA agreement begins by observing that:

> The parties recognize the importance of enhancing the integration of North American energy markets based on market principles, including open trade and investment among the parties, to support North American energy competitiveness, security, and independence. The parties shall endeavor to promote North American energy cooperation, including with respect to energy security and efficiency, standards, joint analysis, and the development of common approaches.[41]

The text covers such issues as maintaining regulatory oversight through authorities separate from those that regulate the industry itself, and also encourages regulatory transparency and procedures for gaining access to electronic transmission facilities and pipeline networks.[42] The latter presumably reflects concerns both in Canada and with the Trump administration in the United States over the permitting process and court actions that delayed the Keystone XL pipeline for many years, including at the present time.[43]

CONCLUSIONS

The Pena-Nieto era energy reforms offer the AMLO administration an opportunity to lay the groundwork for an increase in Mexico's hydrocarbons production in the future, even if the current decline in the country's production and exports probably could not be fully remedied between now and 2024 when AMLO's term ends. The USMCA may also help preserve foreign investor confidence by making the traditional ISDS protections available in the event of hydrocarbons-related disputes with the Mexican government or Pemex. However, there is no assurance that wise energy policies will be pursued. Early actions by the administration—particularly AMLO's strong support for Pemex, tasking Pemex to construct a new oil refinery, and a moratorium on further lease auctions—are more than sufficient to raise questions as to whether current policies will stem or increase production declines.

The USMCA may also help preserve foreign investor confidence by making the traditional ISDS protections available in the event of hydrocarbons-related disputes with the Mexican government or Pemex. However, there is no assurance that wise energy policies will be pursued.

ENDNOTES

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